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MONEY EXCHANGE AND BANKING

BY

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FOREWORD

BY

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FOREWORD

'Money, Exchange, and Banking,' by Professor C P Srivastava, is a systematic and very valuable contribution to the subject which will be found useful for the students of the Intermediate and Degree classes in Economics and Commerce. There is no dearth of books on this subject, but there are very few books which could meet the needs of Indian students in the way in which Professor Srivastava tries to meet them.

The subject has been explained in a clear and lucid manner and has been written in a simple, easily intelligible and comprehensive style. Every effort has been made to make it up to date. Problems of Currency and Exchange are so intricate that only a teacher of vast knowledge and long experience can bring them home to our students. Professor Srivastava, after specialising in Advanced Banking and Public Finance for his B Com Degree, has been teaching the subject to the Intermediate and the Degree classes for the last fourteen years and is therefore well qualified for the task. He has realised the difficulties of the students in understanding the subject and has very admirably tried to remove them.

The book has been divided into two parts and the topics dealing with Indian Currency and Exchange have been thoroughly and fully explained. The fundamental principles of Currency, Exchange and Banking have been very

suitably 'illustrated with Indian examples and the various documents and instruments used in Banking have been amply illustrated. The latest developments in the Arts of Central Banking have also been very lucidly dealt with.

The book will not only serve the valuable purpose for which it is written, but will also appeal to a wider circle of businessmen and industrialists who are naturally interested in monetary problems. I congratulate Professor Srivastava for making this valuable contribution to the existing books on the subject.

Cawnpore	}	KALKA PRASAD BHATNAGAR
July 20, 1940		<i>Dean, Faculty of Commerce, Agra University</i>

PREFACE

The present work is the out come of my long-felt desire to place a suitable text book on Money, Exchange and Banking with special reference to India in the hands of my students preparing for the Intermediate in Commerce and B Com Classes. It has grown mostly out of my class notes and is intended to serve as a text book primarily to the Intermediate Students. The difficulties of beginners in grasping the essentials of the intricate problems of Currency and Exchange have been kept in view throughout the book and the subject-matter has been treated in a very simple, easy and intelligible style. My only excuse for adding this volume to the books extant is that most of them are deficient in one or the other respects and do not present the subject matter in a comprehensive manner. It is the persistent demand of the students themselves which has encouraged me to undertake this work.

The book has been divided in two parts. The first part deals with problems of currency and exchange and with the Indian Currency System, and the second with the principles and the Law and Practice of Banking. The forms of various documents in use have been amply illustrated and the information supplied is most up-to-date. In the preparation of this work I have consulted a score of latest books on the subject both Indian and foreign, and I am deeply indebted to their authors. The collection, sifting and synthesising of the matter has meant a lot of work, but I

shall feel myself amply rewarded if the book is found useful by my students of both the Intermediate and B Com Classes I am confident the book will prove useful to the general readers and students of Economics in Arts as well

I am very grateful to Lala Kalka Prasad Bhatnagar, M A , LL B , Dean of the Faculty of Commerce, Agra University, and Principal, D. A-V College, Cawnpore, for his very kindly introducing the book to the students.

D. A-V College
Cawnpore,
20th July, 1940

C P SRIVASTAVA

PREFACE TO THE SECOND EDITION

The encouraging response given to the First Edition of the book cleared in so short a time and its wide recognition both by the students and teachers of the subject in the United Provinces Rajputana Central India and Ajmer and in Bengal has been a source of great inspiration and satisfaction to me. I am very grateful to them all for this wide recognition and especially to my erstwhile colleague and friend Dr Babu Ram Misra M A Ph D and Prof S D Kalelkar M A (Oxon) of the Benares Hindu University for their very valuable suggestions and constructive criticisms for the improvement of the book. I have taken the opportunity to thoroughly revise recast and enlarge it and to make the subject matter as upto date as possible. One chapter more describing the effects of the present titanic war on Indian Currency and Exchange and the measures enacted by the Government to solve the intricate war time problems of currency exchange and finance has been added. I shall feel obliged to the teachers of the subject in the various colleges and universities if they will kindly offer their valuable suggestions and criticisms for further improvement of the book.

15th January 1942

C P SRIVASTAVA

PREFACE TO THE THIRD EDITION

The book has been revised and the last chapter dealing with the present war and Indian Currency and Exchange has been brought up to date

4th Sep , 1943

C P SRIVASTAVA

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CHAPTER I

INTRODUCTORY

In the modern age we live essentially by exchange. Most production is intended for the market. We do not produce all things, which we require for our daily consumption, by ourselves, but we specialise in producing one thing or another or in rendering a service to others. We then sell or exchange our products or services for what is called money with the help of which we buy whatever and in whatever quantities we like for satisfaction of our wants. Between the producers and consumers there is a long chain of middlemen and both production and distribution to the consumers of most commodities require a co-operation of many men and of many factors. Exchange therefore helps us to specialise nay, it helps even localities and communities to specialise in the production of those things only for which they have the best natural or acquired advantages. This principle of specialisation or division of labour is the fundamental basis of the organisation of modern society and it presupposes the existence of exchange. In fact, if we accept the principle of division of labour then exchange follows

from it as a corollary. Such a complex society based on division of labour and exchange cannot function without *money*.

Exchange is a free and voluntary transfer of surplus wealth from one man to another from one place to another or from one time to another. It is of two kinds: direct and indirect. In the initial stages of economic life wants were few and simple. Every body produced whatever he wanted to satisfy himself. The satisfaction of wants was direct. Even then the surplus product of one could be exchanged directly for the surplus product of another. But this stage of selfsufficiency was gradually succeeded by the indirect methods of satisfying wants. People realised the benefits of division of labour at a very early stage and a very simple form of specialisation ensued. Still the direct method of exchange called Barter or Natural economy prevailed. Barter¹ has been defined as the exchange of "the comparatively superfluous for the comparatively necessary". It is a direct system of mutual and voluntary transfer of wealth between two parties each being in consideration of the other. This system of exchange is possible only under certain conditions and even then it does not necessarily lead to the mutual advantage of both parties to the exchange.

1 W. S. Jevons. Money and the Mechanism of Exchange

Conditions of Barter

There are always two parties to an exchange transaction. Exchange by barter is possible only when each party to the transaction has a desire to possess the thing of the other; each of them has something to offer in exchange, i. e., each has some means to exchange; and each of them is willing to sacrifice his means to obtain the thing of the other. Until all these conditions are fulfilled, exchange is impossible. For example, if Mohan has a pen and Sohan a knife; exchange between them will take place only when Mohan will rather have Sohan's knife than his pen and Sohan likewise will rather like to have Mohan's pen than his knife. If Sohan wants anything else than a pen exchange will not take place. In other words, if exchange by barter is to take place, there must be a "*double coincidence of wants*" - "A man must find another who both has what he wants and wants what he has" ².

Difficulties of Barter

Lack of Double Coincidence of Wants :—This double coincidence of wants is one of the greatest difficulties of Barter. A man desiring to get anything in exchange of his own must search out another who has got the thing which he wants to

² F. Benham : Economics p. 338.

have and is at the same time willing to get the thing in exchange which he is willing to offer. If he is able to find out a man who has the thing he wants to have but that man is willing to exchange his thing not for what he is prepared to offer but for something else then they cannot exchange. This entails a loss of time in searching out a suitable person for his purpose and causes a good deal of inconvenience. It is very cumbersome and tedious. Hence, double coincidence of wants is neither always possible nor easy even in case of finished goods. Trade under such conditions is bound to be limited in its volume and variety.

Lack of a Standard, or common measure, of

—The second main difficulty with barter is that there is no standard of value to enable the parties to exchange to compare the relative values of their respective possessions with each other. If there were a common medium of exchange, the values of all things would be referred to it and by virtue of its service as a common denominator of all values, such an intermediate commodity would enable a comparison between the objects of exchange as to their relative values and costs. For example, if *A* has wheat and *B* has rice and both of them want to exchange, then without a standard of value being there, they cannot find out how much wheat should be exchanged for so much of rice. In the absence of a common measure of value, therefore, there would be

very few well-defined and universally acceptable market values. A good deal of time would be lost in higgling and bargaining between individuals to determine the relative values of their disposable possessions.

Lack of Divisibility :—Then, the third fundamental, and by far the greatest, difficulty of barter is the impossibility of dividing a thing into many parts without loss of utility and exchanging the different parts for different things from different persons when all the requirements of a man cannot be had from one man in exchange for one thing. In this case all these basic difficulties of barter become most glaringly manifest. For example, if A has a cow and wants to get in exchange some corn, a little of salt, spices, a pair of dhoties and a pair of shoes, his position under Barter is most unenviable. It is impossible for him to find out a man who has got all the things in the required quantities that he likes to have and is willing to get a cow in exchange. What a loss of time and inconvenience it will cause can be easily imagined. It is impossible for him to divide the cow into various parts and exchange the different parts of the carcass for different commodities from many persons, because then there shall be an enormous loss of utility and excepting a cobbler, who can spare a pair of shoes nobody will like to have it,

Displacement of Barter by Money

It was to escape from these fundamental defects and difficulties of Natural Economy or Barter the cumbersome and time-wasting method of direct exchange, that man at a very early stage of economic development, hit upon the plan of indirect method of exchange, in which goods and services were not exchanged directly for goods and services, but they were exchanged through the mediation of a third commodity, commonly called a medium of exchange and measure of value or *money*. Any commodity in general or universal consumption or demand, suiting the stage of economic development attained by the community concerned, was chosen to act as an intermediary and its general or universal acceptability led to its service as a medium of exchange and measure of value. A host of commodities and of a wide variety had been in use in various countries in the past as common media of exchange. For example, corn, cattle, tea, tobacco leaves, wampum, glass beads, furs, salt, cloth, slaves and females, Cowrie shells and pieces of skin etc, had been used as money in the past in many countries. But all these commodities suffered from certain serious defects in their service as measure of value, and for various reasons, which we shall discuss in the following chapter, they were gradually supplanted by the precious metals—gold and silver—which were adopted as money all over the world.

This indirect exchange of money splits up the exchange into two—a sale and then a purchase. But this seemingly roundabout and doubling of the transactions makes exchanges much more easy and convenient, and also makes it possible to have place and time exchanges on account of the money being the universal measure of value and transferor of value from place to place and time to time. It facilitates exchange and dispenses with all the difficulties of barter. Now, to take the previous example. A can sell his cow for a few rupees and can buy whatever he likes to the extent of the money that he gets from selling his cow. There is no more the necessity of double coincidence of wants and as the value of all things are expressed in money, we can easily determine by reference to their relative prices as to how much of one thing should be exchanged for so much of the other. Moreover, money is divisible and this fact of divisibility facilitates exchange even in the smallest quantity. The Rupee *e. g.* can be split up into smaller units of account like eight annas, four annas, two annas, and one anna bits and even into pice and still further without any loss of value and utility. Money commands all other things in exchange in this age of money economy in fact, money is King. As one writer puts it, "Whoso has six pence is sovereign (to the length of six pence) over all men, commands cooks to feed him, philosophers to teach him ;

kings to mount guard over him—to the length of six pence ”³

The machinery of exchange now-a-days comprises four M's, which constitute its component and indispensable parts. These are Merchants, Means of communication and transport, Markets and Money or the Mechanism of exchange. In the present work we are concerned only with last one of them *viz*, money

³Quoted by *W.J. Weston*, *Economics for Businessmen*, p 152

CHAPTER II

MONEY

Its Nature, Functions and Importance

Money occupies a central position in modern economic life. All business transactions, all borrowings and lendings, all exchange operations are effected through money, and the productive activities—trade, industry, commerce and services are based on it. What is this money which every body hankers after?

It is fairly difficult to define money. Various writers use the term in different senses. Some use it in a narrow sense while others use it in a wide sense. In the narrow sense it is used to denote coins, bank notes and currency notes which are generally current in a country and are universally accepted in legal discharge of debts without any demur or hesitation. In the wider sense, it comprises all media of exchange and circulation which are generally current in settlement of transactions and includes besides coins and notes, cheques and bank deposits, bills of exchange and Hundies, promissory notes and stock exchange securities etc. Kinley¹ has classified all

¹Money

exchange, as a measure of value, as a store of value and as a standard for deferred payments *Seligman* defines it as "money is the one thing that possesses general acceptability"⁶ *Robertson* uses the term money 'to denote anything which is widely accepted in payment for goods, or in discharge of other kinds of business obligation'⁷ *Cole* defines it as "Money is what buys things—purchasing power"⁸ *Keynes* writes "money is that by the delivery of which debt contracts and price contracts are discharged and in the shape of which general purchasing power is held"⁹

Nature of Money

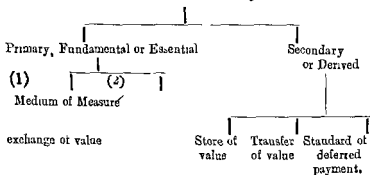
Money therefore is a means by which we exchange our commodities and services for those of others, by which we measure or compare the values of different things. It is an "option bearer" giving command over not one but one of many things and "allows the consumer to take his real income at the time and in the manner that suits him best. It is a certificate that the claims a man has upon the stock of goods will be honoured and anything that is acceptable among men as such certificate is money."¹⁰ It is a definite, a tangible pledge that the recipient can get it ex-

⁶Principles of Economics ⁷Money ⁸What every
body wants to know about Money ⁹Treatise on
Money ¹⁰W J Westcott Economics for Business
men 1 153

changed for goods and services of others whenever and wherever he likes.

Money is, therefore, general purchasing power. It gives a command over all goods and services. It is not an end in itself but a means to an end. We want money not for the sake of its possession but because it is a means to procure all sorts of goods and services for production and consumption. Its demand is therefore based on the demand for goods and services which it can buy. It is only a measuring rod, a unit of value and account and a measure of intensity of one's desire for a thing. It helps us to save and transfer wealth, to store value and to defer our claims to the future. It is simply an intermediate commodity which facilitates exchange and enables us to compare the values of different things.

Functions of Money



“Money’s a matter of functions four,
A medium, a measure, a standard and a store.”

The functions of money may be classified into primary and secondary functions. The primary functions are those which it performs in all stages of economic development. They are services as a medium of exchange and as a measure of value, and the secondary functions depend on the essential services, and are the services as a store of value, as a transfer of value, and as a standard for deferred payment. Besides this money performs some contingent functions¹¹ also which are as follows :—(1) the distribution of social income (2) the equalisation of marginal utilities in expenditures (3) forming a basis of credit and (4) giving a generic form to capital.

The first essential function of money, therefore, is to facilitate exchange by serving as a *medium or a means of exchange*. Money does this because of its general acceptability. The values of all other commodities are expressed in its terms, the inconveniences of barter, namely, lack of double coincidence of wants, lack of divisibility and of a common standard of comparison have been removed. This is one of the fundamental functions of money which is true of all stages, but the more of the present day complex economic life. It facilitates large scale production and division of labour by facilitating the distribution of joint income. It

¹¹ *Kinley*

helps us to buy and sell commodities and services conveniently and readily by acting as the universal means of payment in society.

As all things are exchanged for money, it is a common denominator of all values, and hence, serves as a *common standard of comparison and measure of value* as well. Value being a ratio or proportion between the exchangeable commodities it can be accurately measured, *e. g.* if 5 seers of rice and 10 seers of wheat can be had for one rupee then we can say that 1 seer of rice is equal to 2 seers of wheat. By its service as a common measure of value, money removes a good deal of trouble from society. Values of all goods are reckoned in money. This function is also true of all economic stages and is of greater importance in the modern complex society based on an elaborate and systematic division of labour and exchange.

Money also serves as a store of value*, because of relatively greater stability in its value. On account of stability of money, whenever we have to store value, it is always profitable and convenient to do so in terms of money. The demand for money is universal and permanent, so there is no loss in hoarding money. Labour is a perishable commodity and therefore services cannot be stored

*Benham prefers to call it a "liquid asset."

while commodities are subject to destruction and to violent fluctuations in their prices.

Money serves as a *transferor of value from place to place and time to time* because of its service as a store of value. Whenever we have to transfer value from one place to another we do so by money and similarly, all lendings and borrowings are effected through it.

Money serves as a *standard for deferred payments*. All contracts which are to be performed in some future time are expressed in terms of money. All long-term contracts or loans involve a period of time before they are liquidated, and if the prices of commodities between the interval of contracting and fulfilment of the contract rise or fall the debtor or creditor, as the case may be, stands to loss. But as the value of money is more stable than that of commodities and all contracts are expressed in terms of money, there is not so great injustice or loss involved in contracts (especially short period contracts). It is ~~h~~because of its being a store of value that money serves as a standard for deferred payments. True it is, that absolute stability in the value of money is an impossibility, but changes in the value of money are not violent. Money, therefore, satisfies the condition that the borrower should repay to the lender, so far as possible, the same value which he borrowed so that

equality may be restored This facilitates dealings in "futures"

Besides these functions, Kinley has described four contingent functions of money, which are true only of the present economic stage Money serves as a *distributor of the joint products of industries* In modern factories production is carried on with a combination of land, labour and capital. It is a joint product of hundreds of thousands of men Without money the apportionment of the joint product of highly specialised industries employing thousands of labourers of varying skill and efficiency and capital will be impossible Secondly, it enables a consumer to so distribute his income on various objects of consumption as to derive an *equal marginal utility* from them and obtain the largest aggregate of utilities. It thus enables him to purchase goods yielding the largest amount of consumer's surplus

Money serves as a *basis of credit*. The vast superstructure of credit is raised on the basis of adequate reserve as capital in the form of money. Banks always keep certain amounts in cash as reserves to meet their demand obligations and they are not allowed to issue notes beyond a certain amount without keeping cash reserves These reserves inspire the confidence of people in the financial stability of the banks on account of which their notes and cheques circulate freely as the media of exchange

Finally, money enables capital to be kept in the most liquid form and gives *a generic value to all forms of capital and wealth*. It thus enables a man to command goods and services in general. To be able to perform all these functions the value of money must be stable.

Importance of Money

"Money is the pivot around which economic science clusters * Whether it is art or literature, science or industry, the guiding star of this age is money. In these days of interdependence of man upon man when the satisfaction of wants has become very indirect and roundabout it is very necessary to have money. Every aspect of life and prosperity of humanity is bound up with it. We live essentially by exchange. We sell our products for money, purchase goods with money, pay to others for their services in money and get money for our services in return, and borrow and lend also through money. Internal trade, foreign commerce are done with money. In fact, had it not been for money and its uses, man would not have progressed in the material civilization as he has done. The greatest fact in the efficiency of production has been the division of labour, which together with its corollary exchange, would not have been so elaborate without money. Money today is the one thing

after which everybody hankers because of its general purchasing power. Joint stock companies and their promotion, partnership businesses, floating of loans by Government, private and public corporations and individuals, the stock exchange with its elaborate machinery, and banking and credit systems—all these are made possible through money. Foreign exchanges arising through international exchanges and dealings are effected through money. In fact, money plays a very important part in social, political, economic and financial life of man.

3 Money is the index of economic progress of peoples. It is the epitome of the history of civilization. As civilization advances, wants of people grow in number and variety, and the monetary system adjusts itself to the changed circumstances. In the beginning stages of economic evolution, money is simple and cheap and credit is but little developed. As trade develops, industry and commerce increase, business becomes comparatively complex and expensive, the system of money also becomes very costly and expensive. When incomes are small and prices are low, a cheap commodity serves the purpose of money, but when incomes increase and the country becomes rich, a variety of commodities begin to serve as money.

4 Money dispenses with the difficulties of barter, namely, lack of double coincidence

of wants, lack of divisibility and lack of a common measure of value, and this facilitates exchange. It enables people to specialise by serving as a common medium of exchange and measure of value.

Money increases production of wealth in society by promoting division of labour and facilitating exchange. In the absence of a medium of exchange nobody would like to specialise in producing a commodity or rendering a service. Greater specialisation, improvement in trade, commerce and industry, production in anticipation of future demand and the profitable exploitation of the natural resources of a country are dependent to a very great extent upon the machinery of exchange. Hence, the capitalistic system of production based on competition and private property would not have been possible but for the use of money.

Money gives a mobility to capital and leads to the concentration of capital in the hands of those who are best able to utilise it. Money gives a command over the real instruments of production, like buildings, docks, railways, godowns, steamships, plant and machinery, raw materials and power and fuel. Money gives a command over consumers' goods and it mobilises capital from less productive to more productive channels. Money helps concentration of capital; joint-stock companies and bankers attract capital from the investors and utilise it for further production of wealth. Through

money loans can be contracted to be repaid in future. It helps saving of wealth and its accumulation and growth of capital through the stimulus of rate of interest.

Money has helped people to be free socially and politically by substituting freedom of contract and competition for custom and status. When rent, wages and prices are paid in kind, they are determined by custom and status. Labourers and cultivators suffer a good deal under this arrangement. There is agrestic serfdom *i.e.*, the cultivators are actually slaves of the landlords. There is an arbitrary exaction of rents and other charges from the cultivators and they do not feel every much interested in their work. But when rents are paid in money, they are free, and they are sure of getting the fruits of their own labour. Commutation of rent into money payment has led to the abolition of serfdom in England and in the European countries. Similarly, payment of taxes in money has created political freedom. When people pay money from their pocket, they feel it, and a civic consciousness grows in them. They become the watchdogs of the public money, and thus compel the executive to meet their demands through the control of the purse. When wages were paid in kind, labourers were given rotten stuffs, but all this social abuse has been removed by payment of wages in money.

Money removes isolation and makes for national and political solidarity by making men interdependent. Villagers come into contact with townsmen through trade and this results in mutual goodwill and co operation.

Money is thus important from many points of view, and the economic and material progress of people is very intimately bound up with it. The development of trade and commerce, banking and credit insurance, foreign exchange, stock exchange operations, division of labour and large scale production, all these are but consequences of money. It is the most important of the machinery of the material civilisation of man.

Money enables a consumer to generalise his purchasing power and to secure the largest aggregate satisfaction by a judicious distribution of his income on various items of consumption. It makes possible specialised production. But its value is unstable and sometimes changes so violently as to cause great shocks and convulsions to the economic institutions and inflict injustice and hardships on certain classes of society. The evils of the modern wage and contract systems and inequalities of wealth distribution are also the results of money. An alternation of boom and depression in trade and production is also traceable to its use.

CHAPTER III

MONEY

Its Evolution, Qualities of Money Material

Money is a general purchasing power and it may consist of anything which is generally acceptable and possesses some utility and value. Without these qualities it cannot serve as a medium of exchange and as a measure and store of value. We have seen in the first chapter that a large variety of commodities have been used at various times as money in different countries of the world. At present we simply laugh at them and are surprised to read that such and such things were used as money. Most of these things—corn, cattle, skin, tea, tobacco, fish, slaves, cowries and beads etc.—suffered from various defects and were not suitable to serve the purposes of an advanced society organised for specialised mass production and exchange. Either they were bulky and hence non-portable or were perishable and lacked uniformity, divisibility and stability. Trade and commerce were hampered very much by want of a universally acceptable and stable commodity which could serve as a store of value and a standard of deferred payments. Therefore, with the evolution of national governments gold and silver which possess all the qualities of a good money material were adopted as standards of value in all

civilised countries. With the development of international commerce, and with a view to economise their use, because they are expensive, even these have been substantially replaced in modern times by paper money of various kinds and by instruments of credit which play a most vital part in settlement of international trade and payment of international debts. The monetary system of any country is in accordance with its stage of economic development and the range of incomes and prices in it.

The material chosen to serve as a medium of exchange must possess certain important qualities¹ without which it cannot efficiently function as a measure of value, a store of value and a standard of deferred payments. *Firstly*, it must possess *utility and value* without which nobody would like to have it in exchange for his goods or services. *Secondly*, it should be generally acceptable. If it does not possess *universal acceptability* then it cannot act as a medium of exchange and nobody would like to have it because he is not sure that others will accept it in exchange for their goods and services. *Thirdly* it should have *scarcity* so as to command other things in exchange and possess value. *Fourthly*, it should have *stability in value*. If its value fluctuates violently it cannot serve as store of value and as a standard of deferred payments. *Fifthly*, it should possess *durability or inde-*

¹Jevons Money and the Mechanism of Exchange

tractibility to withstand wear and tear and to be hoarded. If it is perishable it cannot be able to store value and cannot function as a standard of deferred payments. *Sixthly* it should possess *portability* or the *capacity of carrying greater value in smaller bulk* so that it may serve as a transferor of value and can be conveniently carried from place to place. *Seventhly* it should possess *homogeneity* or *uniformity in quality* to facilitate exchange and its passableness and to be capable of being massed or aggregated together without loss of utility and value after dividing it into parts. Hence it should have *divisibility* as well for making small payments. *Eighthly*, it must have *cognisability* i.e., it should be capable of being easily recognised and difficult to be counterfeited else people will run the risk of being cheated by fraudulent persons. *Finally*, the commodity chosen to serve as money must have *malleability*, *fusibility* and *ductility* to facilitate its coining. It should be capable of being broken to pieces melted and fused together in a mass without loss of utility or value.

None of the commodities which were used in the past as money possessed all these essential qualities. But all these qualities are found only in gold and silver and because of this they have been universally adopted as money throughout the world. Their sheen and lustre and consequent attractiveness and suitability for

personal adornment make them universally desired objects and hence, generally acceptable. They are valuable, scarce, homogeneous, portable, durable, and malleable, cognisable, fusible, and ductile. As Seligman says "Beginning in Lydia and Aegina in classic antiquity silver and gold were finally selected in every developed community to receive the government stamp as minted or coined money, because they possess in a peculiar degree the attributes of transportability, divisibility, homogeneity, great value in small bulk, durability, recognisability, stability and adaptability to coinage through fusibility, ductility, and malleability."

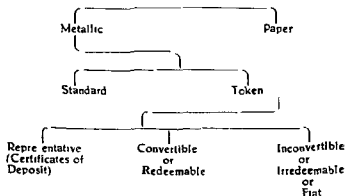
Classification of Money

Money is classified by various writers in various ways. Seligman has classified it in three ways (a) Actual and Ideal (b) Metallic and Paper and (c) Standard and Token. Actual money means that which actually circulates and is current, ideal is that in which accounts are kept. Metallic money refers to coins, and paper money to notes issued by governments or banks. *Standard money* is legal tender for all debts and is used as a standard of value to which the values of all other things are referred for adjustment, it may or may not be coined and may be gold or silver or paper. Token or subsidiary money is used for small

payments and its legal value is higher than its intrinsic value. It is a government monopoly. Paper money is further classified into representative, fiat and fiduciary or inconvertible and convertible paper money. We shall discuss all these in the chapter on Paper Money.

Keynes³ distinguishes between Money of Account and Money Proper and refers to the former as that in which debts and prices etc are expressed, while money itself as that the delivery of which leads to a discharge of debt and price contracts. Sometimes it is called real money because it passes in exchanges, while the money of account refers to bank money which measures value⁴. However, the following is the most common and popular classification of money —

Money



³A Treatise on money ⁴Benham refers to it as the unit of currency and the unit of account the former is legal tender

CHAPTER IV

METALLIC MONEY

Its Evolution and Coinage etc.

Mettallic money at present consists of coins round in shape with milled edges and with a certain effigy impressed upon them. They may be coins of copper, nickel, silver, gold, etc. But when gold and silver were used as money in the beginning they were not of the present form or shape. At first they were used in the form of ingots, bars, disks, or spikes, and lumps of them passed as standards of value. They had therefore, to be weighed, assayed and tested and for this purpose people had to carry weights and measures and touch stones with them. Gradually there grew up the practice of some notable individuals stamping their own marks on private ingots which were probably of certified weight and fineness. People known to such persons or having confidence in them accepted their fineness and simply weighed them when offered in exchange. This system of *currency by weight* was of course very tedious and hampered the development of trade and provided an opportunity to the fraudulent to deceive others. Hence, this svstem was gradually supplanted by *currency by tale* (counting)

In course of time certain individuals and private firms were licensed by the kings to issue coins and therefore they probably differed in their fineness. These were not round in shape. Some of them were also punched. They were stamped on one side only. They rendered weighing unnecessary and passed by mere counting. To that extent they simplified the system of currency. This was the beginning of coinage. But the dishonest goldsmiths and others practised their nefarious activities of tampering with the fixed fineness and weight of the coins by *chipping i.e.*, cutting small portions from the edges of the coins, by *Sweating i.e.*, reducing their weight through corrosive chemical, and through *abrasion i.e.* putting coins in a bag and removing small particles by shaking them violently. Gradually then the governments or states in order to control this undesirable tampering with the coins and to give the much needed uniformity in their shape, weight and fineness began to practice coining on their own account. Coining now became a government monopoly and the weight and fineness of the metal in the coins began to be certified by the stamps or effigies impressed upon them by the currency authority. Coins now began to be flat and round in shape, and were stamped on both sides, but the goldsmiths could still debase the coins by abrasion and therefore the next stage in the evolution of coinage was the

introduction of the practice of milling the edges of the coins, so that any tampering with their standard weight and fineness could be easily detected. Hence, we find today coins round in shape, milled at edges and stamped and ornamented on both sides.

Coinage

A coin is a piece of metal whose standard weight and fineness is certified by the stamp of the Government impressed on it. The manufacture of these stamped and certified pieces of metal is called *coinage*. It may be defined as the act of certifying the standard weight and fineness of the pieces of metal which the society has chosen for serving as a medium of exchange and measure of value.

Coinage is of two kinds *Free and Restricted or Limited*. *Free Coinage* is one in which the public is at liberty to bring bullion or uncoined metal to the mint and get it converted into coins at a nominal charge or free of charge. If in addition to free accessibility no charge is made by the Government for coinage the coinage is said to be *Free and gratuitous*. The English sovereign, for example, had a free coinage till the Great War. The mint exchanged sovereigns at the rate of £ 3 17s 10½d per standard ounce of gold brought to it for coinage. This was

* Coins are stamped and certified pieces of metal.
Tauszig

the *mint price of gold* If the people were not prepared to wait for the turning of their bullion into coin and demanded sovereigns at once from the Bank of England they received only £ 3. 17s 9d. The difference of 1½d. per ounce of gold was charged by way of interest and not for the cost of coining. Therefore, the pre-war coinage of England was free in both senses—free accessibility of the mint and free convertibility of gold into sovereigns In other words it was both free and gratuitous Free coinage however, may be with or without gratuitous coinage

Restricted or Limited coinage exists where the coining is done only on Government initiative and no individual is at liberty to carry bullion to the mint and get it converted into coins. Coinage under this system is a Government monopoly and free access to the mint is denied to the public The Government makes a very heavy charge for coining in this case In India the coinage of the rupee has been restricted ever since 1893

Objects of Coinage

The chief object of a sound system of coinage is to secure uniformity and easy cognizability of the coins Uniformity in size, shape, weight and fineness makes it convenient for the coin to pass current by mere telling or counting. Another object

of a good system of coinage is to prevent counterfeiting and imitation by imparting accurate and uniform weight to the coins. In order to achieve these objects, in all advanced countries coinage is an exclusive function a monopoly of the Government or State. There are many other cogent reasons for public as opposed to private coinage. The sanction of the Government behind the coins would promote their universal acceptance. The fundamental cause for the circulation of anything as money is the confidence of the public in the financial stability and integrity of the issuer. This confidence can be inspired more by State than by private, individual or firm, monopolists. The standard weight and uniformity in size shape and quality of the coins can be secured and maintained only when coinage is public. Private coinage leading to a diversity and heterogeneity of coins would hamper the development of trade and commerce. There would be a constant need of weighing coins if they are issued by different persons and institutions. There is a profit on coinage which in equity belongs to the public, and if coinage is a private monopoly then the profit would be reaped by certain individuals only. Moreover in private coinage it is difficult to verify the accuracy of devices printed or stamped on coins for certifying their weight and fineness and this difficulty makes fraud easy, and the

poor and the ignorant particularly are exposed to the danger of light and spurious counterfeit coins. Competition in this case would be most unscrupulous.

Certain Terms re . Coinage and Coins etc

The conversion of bullion into coin may be done for a charge or *gratis*. Any charge for such conversion is called *Mintage*. If the charge is just equal to the actual cost of coinage, it is called *Brassage*. If the charge made by the mint is in excess of the actual cost of coinage, it is called *Seigniorage*. However, the term *Seigniorage* is used very loosely and means simply a profit on coinage. Both *brassage* and *seigniorage* take usually the form of a deduction from the quantity of the standard metal for minting, in the former case, the deduction is equal to the real cost of coinage, while in the latter case it is more. It is an addition to the actual cost of coinage, it is a net gain or profit on coinage accruing to the Government. Therefore *seigniorage* is sometimes defined as the charge made by Government in receiving bullion at its market value, and deducting a certain amount before or after coinage, *the difference between the bullion and the mint value of the coin*. Thus, *seigniorage* is used in three senses (a) *brassage*, where it is a fee, (b) an additional charge, where it is a tax, and (c) gain or profit arising from converting bullion of a low market value

in coins of higher face value. In all these senses it involves a discrepancy between the value of the coin and that of its bullion. The Indian Rupee before 23rd December 1940, for example was worth 10d. as bullion but 18d. as a coin. So there was a seigniorage of 8d. per rupee on it. *Remedy of the mint, Tolerance or Deviation* means slight variation permitted by law from the exact standard weight or fineness of the new coins. *Debasement* means an authorised reduction or diminution in the weight of the pure metal in a coin or a change of the metal by lowering the standard or fineness of the metal in the coin. It also refers to the raising of the face value of a coin and making it legal tender at a higher rate than before. It was practised very frequently by Governments in the past to secure revenue or to prevent the exportation of coins. The Indian Rupee, for example, weighs 180 grains of standard silver and is $11/12^*$ fine. In other words it contains according to the Indian Coinage Act 165 grains of fine silver and 15 grains of alloy. If without change of the statutes the pure or fine silver content of the rupee is reduced from 165 to 145 grains and the amount of alloy is increased from 15 to 35 grains, then there will be debasement of the rupee.

Since 23rd December 1940 the fineness of the Rupee has been reduced to $\frac{1}{2}$ i. e. it is now $\frac{1}{2}$ fine silver and $\frac{1}{2}$ alloy.

to that extent Debasement therefore means difference between the standard value of the metal fixed by law in a coin and the actual value of the metal contained in it

Legal tender means the offer or tender of money in payment of a debt which the creditor is compelled by law to accept in final discharge of an obligation. It is of two kinds *limited* and *unlimited*. Under *limited legal tender* the creditor can be obliged to accept the tender of certain forms of money only upto a limited extent, whereas in the latter case he can be compelled to accept the money enjoying this attribute to an unlimited extent in full and final discharge of the indebtedness of the debtor to him, either in the present or future. The declaration by the State that such and such thing shall be legal tender within the country prevents uncertainty of contracts and protects ignorant and weak creditors from being imposed on with spurious money. The Rupee and Eight annas bits are unlimited legal tender in India while the smaller coins are legal only upto Re 1. In England in the prewar days the sovereign was unlimited legal tender and the shillings were and are even today limited legal tender upto 40 s only. This legal tender characteristic is not enjoyed by coins only. Currency and Bank notes are also made unlimited legal tender as in India (Currency and Bank Notes). R

Notes) and in England (Treasury Notes of £ 1 and 10 s and Bank of England Notes)

Standard vs. Token Coins

Standard Coin is that stamped and certified piece of metal which is adopted as a standard of value and to which the values of all other subsidiary coins and tokens are adjusted. A full-blooded standard coin has three characteristics viz free coinage; unlimited legal tender; and the same value as bullion or as coin, (its intrinsic value or value as metal and its face value or value as coin is the same), sovereigns and half sovereigns for example, in England before 1925 and the American Dollar. The sovereign weighed 123 274 grains and was 11/12 fine so it contained 113.0016 grains of fine gold. In most countries it is a gold coin. A *Token coin*, on the other hand, is a subsidiary coin whose coinage is limited or restricted, which is a limited legal tender and whose face value is much higher than its intrinsic value. It is usually made of baser metal, is intended for making small payments only and its supply is a government monopoly *e.g.*, the shillings and pennies in England and the four annas, two annas and one anna bits in our country. The Rupee in our country is unique in this respect. It is a Standard-Token coin; hybrid coin. It is in fact a token coin, an "inconvertible note printed on silver."

But it has been made by law unlimited legal tender, and hence, a standard coin although it has two features of token coin in it viz, restricted coinage and higher face value than its metallic content warrants. Its face value is 18 d but intrinsic value before 23rd December 1940 was only about 10 d

Standard money need not be coined. Under the Gold Exchange Standard in India sovereigns and half sovereigns were standard money but they were not coined here. Similarly under the Gold bullion Standard gold is standard money but it is not coined. At present the Pound Sterling is the standard money in England since September 21, 1931.

CHAPTER V

PAPER MONEY

As pointed out previously money may consist of coins or notes and other media of circulation. In every country today paper or note currency forms a very important part of the monetary system, and with the development of its economic life, the status and the importance of paper money has increased. Paper money has been in vogue from very early times. Probably the credit of developing paper money goes to China where it was in use in the 9th century*. Modern communities introduced convertible paper money on a large scale in the latter part of the 17th century and by the 18th century inconvertible paper money began to come into use in countries which had been habituated to the use of convertible paper and possessed strong governments¹. It displaces metallic money to the great advantage of the country using it. Not only it is cheap, but it also saves the loss through wear and tear of metallic money. It is also very convenient for making large payments and its use secures economy in making all pay-

*Kinley

¹F W Taussig Principles of Economics p 303

ments within the country at distant places. It is the best money under ideal conditions and the worst in their absence.

Paper money has been classified into three kinds — (a) Representative (b) convertible or Redeemable Fiduciary and (c) inconvertible or irredeemable or fiat. *Representative* paper money is one which represents gold and silver bullion or coins and brings about an economy in their use. There is an equivalent deposit of gold and silver with the issuing bank or Treasury for every note issued. It is in fact a certificate of deposit and represents so much gold and silver deposited with the currency authority, *e.g.*, the certificates of gold and silver deposits in U S A where a deposit dollar for dollar is kept with the Treasury as a security against the issue. They are as good as the coins or bullion so far stability is concerned and simply represent them in circulation. They are therefore the safest form of paper money and are more convenient to handle than specie. There is no danger of their over-issue in as much as there must be a corresponding metallic reserve to warrant their conversion into legal tender money. They are not legal tender but public dues like taxes and customs are paid in their terms. The Hilton Young Commission had also recommended the issue of gold certificates by the Government of India, but the recommendation has not been given effect.

to the Government. Such paper money is very rare.

Convertible paper money consists of currency or bank notes which are converted into standard coins on demand at any office of issue or treasury *e.g.*, the currency notes in India, the Reserve Bank Notes or the Bank of England notes before the War. They are full legal tender for all debts. The quantity of specie kept in reserve to maintain their convertibility is usually much smaller than the face value of the notes issued because in normal times very few note-holders present their notes for conversion at the same time. The portion of note issue not covered by metallic reserve is secured by investments in Government securities and is technically termed the fiduciary or invested portion. Such notes supplement the coins and expand the currency, they are not primarily meant to supplant or replace metallic money.

Inconvertible² paper money consists of such notes as are not capable of being converted into coins or specie. They contain apparent promises to pay in specie but these promises are not intended to be redeemed. They circulate on account of the prestige of the Government and the confidence of the public in the stability of the state or by mere force of law. If it is inconvertible from

² Conventional paper money represents nothing and confers a claim to nothing. *Gide.*

the time of issue, it is called *fiat* paper money because its acceptance and value depend upon the *firman* or order of the Government. The classical examples of such notes are the French 'assignats' issued during the French Revolutionary wars and the 'greenbacks' of America issued during the Civil War of 1861-1865. After the Great War of 1914-18 the paper currencies of all the European countries and notably of Germany, Austria and Russia were inconvertible. The 2½ and 1 Rupee notes of the Government of India issued during the Great War were fiat papers. The present 1 Rupee notes are also of the same brand. Paper money strictly speaking refers to this inconvertible type which is ordinarily issued when the Governments are very hard pressed for money in times of war or national emergencies. It is generally made legal tender for all private and public debts. It is in the nature of a forced loan from the people without any interest charge or a tax without their consent. Therefore it is very unpopular and when the Government stock is low it is at a heavy discount in the market. The 2½ and 1 Rupee notes were reported to be at a discount of 15 to 19 percent in some places in 1918.

Advantages of Paper Money

- 1 It is very convenient to handle
- 2 It is very cheap as it "costs

trifle" To manufacture it only some paper, ink, and a printing press etc are required

- 3 It economises the use of precious metals or gold and silver coins to the extent that it replaces metallic money The metallic money thus released may be invested in development of industries and trade or utilised in arts and thus become a source of an income
- 4 It saves the loss arising out of wear and tear of coins when they are in circulation
- 5 It is cheaper and more convenient to remit money through paper than metallic money It can be made of any denomination and is much less risky and cumbersome to carry than coins A bag of thousand rupees, for example, carried over shoulders will excite the jealousy of undesirable persons and imperil the life of the person carrying it, but a thousand rupee note can be very easily kept in the pocket and no body can even guess that the man carrying it possesses a large amount of money The cost of remitting a heavy sum by M O shall be very large but thousands of rupees can be sent in an insured cover at a nominal charge in form

- of currency or bank notes Large payments can be made more conveniently and cheaply through it
- 6 It relieves the labour and capital employed in production of gold and silver for coining purposes to be utilized in the production of other goods and more necessary articles of consumption if all countries adopt paper money
- 7 It makes the currency system very elastic because whenever there is an increased demand for money, it can be easily, cheaply and quickly manufactured to meet a monetary stringency.
- 8 There is a great fiscal advantage to the government in that the issue of paper money amounts to an indirect form of taxation It is taxing the public behind its back without the knowledge that it is being taxed, and therefore, it comes very handy to a government in times of need It saves a good deal of interest to the government which otherwise it would have to pay on loans borrowed for payments to its officers, servants and contractors In difficult times when the money market cannot be tapped profitably for loans, the Government issue inconvertible notes which amount to loans without any interest charge

Disadvantages

But at the same time the use of paper money is fraught with dangers on account of its value being precarious and uncertain, wholly dependent as it is on the sweet will of the government issuing it or on the security of the assets of the issuing bank. Its value is simply legal and customary and the holders of it lose all on their repudiation or cancellation by the Government of the day. Unlike the Rupee coins, for example, the one rupee note has no intrinsic value. It has a restricted area of circulation and cannot serve as an international money. It is also subject to destruction by water, fire, oil etc. The supply of paper money can be increased at the caprice of the government and the latter may issue it in increasing quantities even though greater supplies may not be required by the community. The result is that the currency depreciates, prices inflate, and an element of uncertainty is introduced in business. This encourages speculation of the worst type. The business community is demoralised and a desire to get rich quickly is stimulated among businessmen. The increase in the quantity of money in circulation and the consequent rise in prices encourage imports and discourage exports. The excess of imports over exports is paid for by the export of metallic money and thus, the metallic

backing or cover to the notes is further diminished. Finally, there is a duplication of prices. Prices are stated in paper and in gold or specie and the two quotations differ from each other by the depreciation in the value of the notes. The *chief disadvantages of paper money* may be summarised as under —

1 Its value is very uncertain and subject to violent fluctuations because variations in its supply are dependent on the issuing authority.

2 Its circulation is confined to the four corners of the country issuing it and outside its boundary it is worth nothing, not even the paper on which it is printed. It is essentially national money.

3 It is not durable and is a fraud on society. It is artificial money and has a conventional value.

4 If it is oiled or dusted, its value as money is *nil*.

5 There is a danger of over-issue with all the bad effects of an inflation of currency which are inflicted on the public. This is the most serious defect in paper money which is still more aggravated if it is inconvertible. Experience has shown that Government note issue is more liable to excessive issue than Bank issue.

Effects of the issue of irredeemable paper money "When a country using metallic

money begins to issue paper money, the first consequence is that *the specie is driven out of circulation*. The metallic money goes to the government for payment of taxes, or it is used in arts, because its price is lowered and hence the demand is increased, or it is hoarded by the people or exported in payment of foreign claims. If there is no increase in demand for the medium of exchange in a country, the metallic money will disappear as fast as paper money is issued. But if the demand increases the metallic money may circulate side by side with paper money. If however, issue of paper money goes on in reasing, it may be able to perform exchanges by itself, the metallic money will be driven out of circulation. Upto this time no positive harm may be done. Positive harm arises from *over issue i e* if it is issued in larger quantities than the specie it displaces. After this its further issue will swell the volume of the home currency and bring about *a rise in prices*."

"The first sign of excessive issue of paper money *i e*, an issue greater in volume than the metallic money whose place it has taken, is a *Premium on gold*. Even when the excessive issue of paper money has been made some payments must be made in gold. Payments to foreign creditors will be made in gold. Gold must be made available in bullion if it is not in circulation. It will be purchased with

paper and some premium will have to be paid for it. This premium will show itself in the rise of the exchange rate. When the paper has depreciated the importer in the home country has to pay more for the foreign bills of exchange than when the paper is at par. Such a state is bad for the foreign trade of the country in which paper money is depreciated. The foreign exporter will demand a more favourable exchange in order to offset the premium. *The burden of the premium on gold diminishes the profits of the export trade* if the country has to make large foreign payments.

"Prices are quoted in paper and not in gold when the former has driven the latter out of circulation. Prices rise with every fall in the value of money." This leads to a boom in production and trade, high profits, speculation and loss to the labourers, consumers, creditors and people with fixed incomes. "When the excess of paper money over the specie displaced is small, prices may remain as under the specie regime, for custom may not allow them to change. Then though the foreign exchange may rise, the prices in general remain stationary. But the appearance of a premium on gold shows that price is to rise and the paper money is depreciating."

Prices under a depreciating paper regime rise faster than is warranted by the in-

crease in the quantity of paper money issued. Paper money derives its value solely from its demand for exchange purposes. Its value, therefore, depends upon the confidence that people will accept it. That confidence grows less as the quantity increases and after a certain point many people may refuse to accept it, and its value may fall much more than the proportion warranted by the increase in its quantity."

To sum up The chief effects of over-issue of inconvertible paper money are —

(i) Disappearance of specie through the channels of international trade in proportion to the issue of paper money

(ii) Premium on gold

(iii) Rise in the rate of exchange

(iv) Rise in Prices

(v) Depreciation of paper money

(vi) Two different sets of prices

(vii) Dislocation of foreign trade.

(viii) Inflationary boom in trade and production, high profits, speculation, high interests and loss to creditors, wage earners, consumers and people with fixed incomes

CHAPTER VI

PRINCIPLES AND METHODS OF NOTE ISSUE

Government vs Bank Note Issue

Notes may be issued either by the government of a country or by banks. In the interests of centralisation of reserves, mobility, elasticity, economy, convertibility and uniformity, it is essential that there should be only one central authority entrusted with the business of note issue. In a Multiple Note Issue in which various banks have a right to issue notes, there is a good deal of competition among the issuing banks and it becomes difficult to maintain universal convertibility. Such notes circulate only within a limited circle of issue among the customers of the banks and create difficulties in exchanges. ^B Therefore the note issue is either ⁴⁹a State monopoly or the monopoly of the Central Bank of the country co-ordinating and controlling both currency and credit supply. Since 1922 in all important countries the work has been entrusted to Central Banks but in some countries treasury or currency notes also circulate side by side. The note issue before 1861 in India was the monopoly of the three Presidency Banks of Bengal,

Bombay and Madras In 1861 it became a government monopoly when there was no elasticity in its issue and to remove it the Imperial Bank of India was authorised to issue emergency currency during the busy season to the extent of Rs 12 crores on the security of genuine trade bills. Since 1935 the Reserve Bank of India has now the sole right of note issue and the old currency notes which are still legal tender have been fused with the Bank Notes. Similarly in England at present the Bank of England notes and Treasury Notes of £1 and 10s circulate side by side both being fused together and controlled by the Bank now.

Those who advocate the issue of notes by banks regard it as the ordinary business of the Central Bank, and argue that there is no danger of issuing paper money in excess of the demand for it, if the notes are convertible. The maintenance of convertibility, and the practice of the principle of sound banking, it is argued, will deter the bank from overissuing the paper money. In other words, the chances of inflation and depreciation of currency can be minimised. Moreover the currency of a country should be elastic *i.e.*, it should be capable of increasing it there is an increased demand for it, and of decreasing when there is a reduction in its demand. This capacity of expansion and contraction of money in response to brisk and slump trade can be regulated more efficiently by

an agency which controls both currency and credit. That suitable agency is the Central Bank of the country. Metallic money does not possess elasticity although it possesses mobility whereas convertible paper money possesses the quality of elasticity. The so called elasticity of money means only a change in its distribution without a change in its volume, whereas paper money implies a larger or smaller supply of it in various places without curtailing the supply at any other place. In busy season *i.e.*, during summer in India, the seasonal demand of agricultural communities for more money must be met by an increased supply of money and as cheques or bank money are not accessible to them, the issue of convertible notes becomes a necessity.

The Central Bank being a Bankers' Bank, providing re-discounting facilities to a number of banks, and controlling the Government Balances, currency and credit, is in a much better position to judge the requirements of the business community for money. Moreover, politicians have never made good bankers and have always made confusion worse confounded.

The advocates of the government note issue say that the grant of the right of note-issue to a private share holders' bank confers on it a special advantage in competition with other banks. It is very unfair

Moreover, the right of note issue carries with it large profits which in equity should belong to the public, and should not be monopolized by the private firms. This, however, can be provided by transferring all profits of the Central Bank, after payment of a fixed dividend to the share holders, to the general revenues of the government as it is in case of the Bank of England and the Reserve Bank of India. Further it is pointed out, that when notes are issued by a government, the entire assets of a nation as a whole are pledged to maintain their convertibility, whereas if they are issued by a Central Bank owned by shareholders, the security for their convertibility is much less. This also is provided for by placing the government balances at the disposal of the Bank. A government note issue moreover carries with it a greater sanction than that issued by a bank. However, the experience of every country practically shows that the governments can not be relied upon to maintain the convertibility of note-issue. They are influenced by their own financial needs and political considerations. There is always a danger of over-issue present more in case of government note-issue than in that of a bank. There is nothing to prevent a government from resorting to it, and specially in bad times it is a very cheap and easy device to tide over the financial difficulties by an over-issue of

notes The society therefore has to suffer very bad consequences of over-issue of money Not only this, the government machinery is very slow to move on account of red tape and therefore the elasticity of currency which is very desirable for stability in prices and incomes is very difficult to be attained The experience of government note-issue in India bears ample testimony to this fact. In India, there has always been a monetary stringency during the busy season *i.e.*, the supply of money has always run short of the demand for it to finance trade, industry and agriculture, and the bank rate has risen upto 8 or 9 per cent Finally, a government note-issue is subject to non-economic disturbances like party politics, military expeditions and budgetary deficits Hence, Note Issue should be entrusted to a Central Bank

Currency vs Banking Principle of Note Issue —There have been two principles of note issue advocated namely *the Currency or Safety principle* and the *Banking or Elasticity principle* The advocates of the first lay emphasis on security and freedom from dangers of over-issue and hold that all notes issued must be backed by a rupee for rupee metallic reserve and that with the diminution of the reserves, the note circulation should be reduced correspondingly. If a Bank has full liberty to issue notes there is a danger of over-issue and inflation of prices with very undesirable consequence

In other words, the expansion of note issue according to these theorists should not depend on the expansion of business and trade but on the expansion of gold and silver mines. This principle sacrifices elasticity at the altar of security and hence it hampers the advance of trade, commerce and industry. The advocates of the banking principle, on the other hand, regard elasticity as of greater importance and hold that the bank should have unfettered discretion and complete liberty to issue notes without limit and without a full reserve in metallic money and bullion, provided sound banking principles are observed and the notes are convertible on demand into specie. Then there shall be no over-issue and inflation of prices. This system satisfies the requirement of elasticity according to which notes should expand and contract in circulation in response to changes in demand for money by the business community. Thus the banking principle secures elasticity but it is not so secure and safe on account of the weakness of the metallic reserves. Under these circumstances, there is a possibility of the Bank crossing the bounds of prudence and proper judgment and thus causing an over issue and inflation of prices culminating in a crisis. The right or sound principle of note issue is, therefore, one which combines both security and elasticity and this can be easily and safely done by modifying

the Banking principle and regulating the note issue by law. The Bank of England Charter Act of 1844 followed the currency principle of Note Issue in which the Fiduciary or uncovered issue was fixed at £14 m. It was a secure but inelastic system the defects of which were removed by developing the cheque system. The regulation of the Central Bank Note issue may be done by prescribing the maximum amount of notes, or by the minimum amount of reserve to be kept in gold coins and bullion.

Methods of Regulating Note Issue

A sound system of note currency should satisfy the following fundamental principles —

(a) *Economy* —It must be economical otherwise it will defeat the very object of its issue viz Economy of gold and silver.

(b) *Elasticity* —It must be capable of expansion and contraction according to the needs of the business community to tide over a monetary or financial stringency and to maintain stability of prices. A rigid system of note issue is not able to do so.

(c) *Security against over-issue* —The provision of elasticity, however, does not mean that the note currency should be issued to an unlimited extent. As has already been pointed out earlier in this chapter, the

greatest drawback of paper money is its liability to an over-issue. An inflation of currency and the consequent depreciation in the value of money leads to a great disturbance in the production and distribution of wealth and changes in prices affect the different classes of society in various ways. Hence, to secure justice and equity in the relations of debtors and creditors and to maintain stability of prices, adequate safeguards should be provided against the danger of over issue.

(d) *Convertibility* — Finally, the ideal method of note issue should aim at the convertibility of the notes. To inspire confidence adequate reserves should be kept by the issuing authority to redeem the notes on demand.

The issue of notes by the Central Banks with the sanction and authority of the State and under strict regulations satisfy all these desiderata of an ideal system of note issue. Security against over issue and convertibility are achieved, broadly speaking, in two ways

either by (a) regulating the reserves or "the ratio system"

(b) or by regulating the quantity of the notes issued by laying down the maximum

On the other hand, the elasticity is secured by authorising the Banks to issue emergency currency against security of

genuine commercial paper, by permitting 'open market operations' and by requiring them to provide rediscounting facilities to the commercial banks and other credit agencies on the fulfilment of certain conditions.

The regulation of the Reserves is done in the following ways :—

(a) *Minimum Reserve Method* i.e. —by prescribing the minimum below which the Reserve should never fall irrespective of the notes issued. It secures elasticity, safety and economy of gold which through investments may bring revenue.

(b) *Simple Deposit Method* —Under this method a deposit of gold and silver is kept equivalent to the amount of the notes issued. It lacks economy and is very rigid although it possesses security against over-issue and convertibility. It refers to the representative paper money and by making the currency wholly dependent on the gold and silver mines causes inelasticity of currency.

(c) *Partial Deposit Method* —In this case only a partial deposit against the notes issued is kept in gold and silver which is called the covered issue and the remainder is called Fiduciary or uncovered note issue. It is an improvement on the former method so far as economy is concerned but there is no adequate safeguard against over-issue and provision for convertibility is meagre.

This system has been practised in England and is called the *Fixed Fiduciary Issue or Reserve system*. The Charter Act 1844 fixed the Fiduciary note issue based on the Fixed Fiduciary Reserve of securities at £ 14 m. but the amount was gradually raised to £ 19,750,000 before 1928. All notes issued beyond this limit were to be covered by cent per cent metallic reserve or gold. The Currency and bank Notes Act of 1928 raised this fiduciary limit to £260 m. normally and also the Fiduciary Reserve ; and authorised the Bank to vary this limit, with the previous consent of the Government, subject to the subsequent approval of the Parliament. Between 1931-33 this limit stood at £ 275 m. All notes in excess of £ 260 m. must be backed pound for pound by gold. This system also prevails in Norway and Japan.

The system is *very rigid and renders the note issue inelastic*, and if the fiduciary limit is fixed low, it *locks up a large amount of gold in a gold standard country without gold coins in circulation*. The defects of the system can be removed by fixing the fiduciary limit at a high figure and by leaving the Bank unfettered to control its reserves. The system is also *uneconomical* for it renders the expansion of currency dependent on the production of precious metals and not on the requirements of trade. It is however, *safe and secure* and is an example of the application of currency principle of Note-issue.

(d) *Proportional Reserve or Percentage Method* — This is an example of the application of the Banking principle of note issue and is most in vogue at present. It means that the ratio of gold to notes issued must not fall below a certain percentage say 40%. Under this system a fixed proportion of the note issue is covered by a deposit of gold and silver bullion and coins and the remainder is covered by a deposit of, or investment in, gilt edged securities, or stock exchange securities which are stable in prices and can be easily and readily converted into legal tender money. It secures *economy, elasticity and security against over-issue*. This is the system adopted by the Reserve Bank of India and by the Federal Reserve Banks of U.S.A. and Central Banks of Germany, Russia and France etc. In U.S.A., Germany and India, a Reserve of 40% is kept whereas in France it is 35% and in Russia 25%. It is an improvement upon the fixed fiduciary method in which every increase beyond the fiduciary limit should be covered by a deposit of gold and silver bullion and coins and the limit cannot be increased without the previous sanction of the Parliament or Legislature. Such a course is liable to cause delay on account of red-tapism in an emergency. The *currency can be automatically expanded or contracted by purchase or sale of the gilt edged securities without the previous sanction of the Government*. The Bank is in a better position than the

Government to gauge the conditions of the money market and act accordingly. Hence, the note issue under this system is very elastic, an increase of 40 m in the reserves makes possible an increase of 100 m in note-issue whereas a decrease will have a reverse effect. Mr Keynes is very much against this 'most fashionable system' and condemns it as most defective. It is *extravagant in locking up gold and does not exempt even the irreducible minimum*. It leads to a *disproportionate increase in circulation on account of an influx of gold and in times of emergencies when gold reserve is falling it causes a dangerously disproportionate and drastic contraction of money*. The reserve under this system is *not able to secure ultimate convertibility for which it is meant* because it must fall below the legal minimum. Only the reserve in excess of this minimum can be utilised. Hence the reserve must be kept in large amounts. This is a waste.

With a view to introduce further economy and to keep only a minimum of gold in the reserves this percentage method is somewhat modified. A part of the legal percentage of the reserve is not kept in gold but in bills or cash at some foreign bank in whose country gold standard prevails. For example, in India of the $\frac{2}{3}$ ths or 4% of the total assets of the Issue Department of the Reserve Bank of India which is to consist of gold coin, gold bullion or sterling securities, the gold coin and

bullion must not be less than 40 crores of Rupees. The balance consists of sterling securities.

Besides these the other methods are the Bond Deposit method in which the prices of bonds play a decisive part in the elasticity of the currency, the Safety Fund Deposit method and the method in which the assets of the issuing Bank are pledged as security against the notes.

As regards the regulation of note issue through its quantity there is the Fixed Maximum method which was followed by France upto 1928. It was recommended by the Mac-Millan Committee of 1931 for England. Under this method law regulates the quantity of notes issued by prescribing the maximum amount irrespective of the reserves. The maximum is usually kept higher than the expected normal circulation of notes and is subject to change for meeting the increased demands of trade. It leaves the Bank in free and unfettered control of its reserves which are available in their entirety for use in times of need. It is a safeguard against excessive note issue and inflation but it suffers from inelasticity by ignoring the well known principle that money should expand according to the needs of business. It lays down the maximum amount beyond which the issue can not increase without a change in law whatever the requirements of trade.

may be. This is perhaps the best system to regulate by law the volume of note issue.

The ideal method of regulating note issue is to leave the Central Bank unfettered to adjust the note issue and credit to the changing conditions of trade and to utilise its reserve for the purpose so that stability of prices may be secured; but to guard against the dangers of over-issue and secure convertibility, it should be required by law to maintain a minimum of gold reserve; and a fixed maximum amount of notes should be prescribed by law which should change from time to time in response to trade and business needs.

CHAPTER VII

CIRCULATION OF MONEY

Gresham's Law

Principle of circulation —Anything can circulate as money either because of persistence of social habit or custom, or the confidence of the public in the financial stability of the issuer, or because the receiver believes that others will accept it in turn from him in settlement and discharge of their claims, or because there is the guarantee or sanction of the government behind it, or finally because there is an agreement among groups of individuals to accept a certain article of general consumption in settlement of obligations

Gresham's Law Different portions of a generally acceptable thing may have different degrees of acceptability. If coins are worn out by constant use and get reduced in weight, or they are debased, and circulate side by side with newer and full weight coins, there comes into operation a law which is named after Sir Thomas Gresham, although it had been known and discovered earlier than him. He, however, drew a pointed attention to it. Gresham was a London merchant and the financial adviser to Queen Elizabeth. He was the founder of the Royal Exchange in London and discovered in his own times that the better portion of the circulating media were withdrawn

from circulation and were melted down for use in arts or exported abroad. This tendency to withdraw the more valuable coins, if there is a great variation in coinage, is so likely that it is commonly said that "*Bad money drives good money out of circulation*". This statement of the tendency is called the "*Gresham's Law*". When two kinds of money, bad and good, circulate together, other things being equal the bad money will remain in circulation and the good money will go out of circulation. *Marshall* has worded it as '*Gresham's Law is that an inferior currency, if not limited in amount, will drive out the superior currency*'.¹ "In every country where two kinds of legal money are in circulation the bad money always drives out the good."²

Ways in which good³ money goes out of circulation — People keep the bad money in circulation for making payment to others so long as it is not refused, and they withdraw the good one from circulation, because its value is higher as bullion than as coin, and therefore, it is melted and sold as bullion or it is hoarded or used in arts or it is exported in payment to foreign creditors. The operation of the *Gresham's Law* seems to be paradoxical, because or

¹ Money, Credit and Commerce

² *Guide* Principles of Political Economy

³ 'It disappears in three different ways by hoarding payments abroad and sale by weight "*Guide*".

dinarily people in their self-interest choose good things and reject bad ones, but in case of money they apparently behave in a different fashion. But the paradox is easily solved if we look at the owner of money as a seller and not as a buyer and remember that money is wanted only for exchange and not for consumption. We have seen that the demand for money is a derived demand, it is meant for getting articles of consumption or production in exchange. Both the bad money and good money have the same value as coins within the country and therefore it is a matter of indifference to the owner whether he uses the good or the bad money in paying to creditors and to businessmen at home so long as both are legal tender. But their value is different as bullion or metal, therefore, the owner of money keeps the bad one for making payment and for circulation and sells the good one for which he gets a better value as bullion. Thus the bad money remains in circulation and the good one goes out of circulation. *Good money is melted and sold as bullion* because it fetches a higher value in that way. Or, the good money after melting is used in industrial arts for the manufacture of trinkets etc. *Secondly*, those who want to hoard money for emergencies will naturally hoard the good and not bad coins because the good coins "offer the most security." *Thirdly*, good money is exported abroad in payment

of foreign debts. The reason for this is that foreigners take the bad as well as good coins at their bullion value and the good coins containing more and finer metal will make up the amount for the payment in a smaller number which will be made up by a large number of bad coins and thus the cost of transport will be higher. Moreover, within the country both bad and good coins have the same purchasing power as money. Obviously therefore, it is to the advantage of the money-holder to retain the bad coins for internal circulation and to export the good ones in foreign payments. *Thus, good money goes out of circulation by hoarding, by its use in industrial arts and by the exports to foreign countries in payment of international debts*

Conditions in which the Law applies:—
Gresham's Law is applicable to the following cases —

- (1) When coins of the same metal and of the same nominal or face value, but differing in their weight, circulate together the lighter coins (bad money) will drive the heavier coins out of circulation. For example, when old and worn out coins circulate together with newly coined full weight coins, the older coins (bad money) will drive the newer ones out of circulation. Gresham discovered the law in this case

- (ii) When coins of two metal—gold and silver—with a fixed legal ratio between them circulate together as standard coins and there is a difference between their mint value and market value in terms of each other, then the laws will operate. Let us assume, for example, that at the mint *one ounce of Gold* in coins, is equal to *sixteen ounce of silver* in coins, but in the bullion market *one ounce of gold* purchases only *fifteen ounces of silver*, then silver as bullion is more valuable in terms of gold than as coin at the mint. Therefore, silver coins will be withdrawn from circulation, melted, hoarded and exported and gold coins will remain in circulation. In this case gold is over-valued money having higher value as coin than as bullion and hence it is bad money, and it drives silver coins which are good money out of circulation. If on the other hand, the market value becomes 17 : 1 then gold will be driven out and silver will be retained in circulation. This often happens under Bimetallism.
- (iii) When metallic money and paper money circulate together as standard money then paper money (bad money) tends to drive metallic money out of circulation, and this ten-

dency shall be stronger if money is depreciated paper money.

Assumptions or limitations of the Law The phrase 'other things being equal' or 'if not limited in amount' point to the limitations under which alone the law will operate or hold good. There are two limitations to the Law —

- (a) That the supply of money of both kinds (good and bad) is in excess of the demand for money,
- (b) That public opinion is ~~not~~ opposed to the use of both good and bad coins at the same time.

For the operation of the Gresham's law it is essential that the aggregate of good and bad coins must be in excess of the country's need for circulating media. If trade is so large and brisk that all the money, both bad and good, is required for effecting exchanges, or that the supply of money, taking both good and bad together, falls short of the demand, then bad money cannot drive out good money. Moreover, on account of the great demand even the good money will have a greater value as coin than as bullion, and therefore, being more valuable as money it will remain in circulation. Under these circumstances, even the value of the inferior coins rises to equality with the bullion value of the full weight coins.

Secondly, if public opinion is opposed to the circulation of both bad and good money

side by side, then on account of its force and influence inferior money will not circulate. A very good example of this is furnished by California and U S A during the Civil War of 1861—65, when California refused to use 'green backs' (inconvertible notes) issued by the American Government and continued to use gold while the other states were using paper. During the post war period people in England tried to return to good money as soon as possible and stabilised their currencies for this purpose in 1925.

Conclusion Therefore, the law needs to be carefully stated. *Kinley* has stated it hypothetically as follows —

"If more than one form of money is legally usable in a country, and if one of these is more valuable for some other use than it is for making exchanges, then the inferior portions of the currency will supplant the superior to the extent that the two portions together exceed the need for currency in the country, provided that public opinion or any other economic force does not interfere with the operation of the self-interest of dealers in money." Or more generally, 'When a community, in which competition is free and intelligent, has a choice of means of payment, it will use the least expensive which will serve its purpose under existing circumstances.'⁴

⁴Money

CHAPTER VIII

THE PROBLEM OF THE STANDARDS

In the primitive stages of economic life when society was organised on the basis of self-sufficiency, wants were few and simple and were directly satisfied. There was no necessity of an elaborate system of exchange. Gradually, however, as society advanced in material civilisation, the satisfaction of wants became complex and roundabout, they began to be satisfied indirectly. Exchange by barter came into existence and division of labour was introduced. With the development of the means of communication and transport, the area of the market widened, and trade, not only in light and valuable articles but also in bulky commodities, developed. Exchange by barter was not able to satisfy the demands of the community and to dispense with its difficulties money came into existence.

With the development of division of labour, of markets and international trade, the problem of a standard of value becomes very important. When the society is organised on the principle of division of labour, methods of production become roundabout and production is carried on a

large scale not for the purpose of consumption by the producer themselves but in anticipation of a future demand and for sale. But specialisation and large scale production presuppose the existence of a well organised system of exchange with all its component parts *viz.* merchants, markets, means of communication and transport and money or the mechanism of exchange. The first three component part of exchange, however, hinge on the fourth and the last one. In fact the wheels of commerce and trade cannot function without the oil, *i. e.* money and credit. True it is that in the first stages of the evolution of the economic life of man exchange is effected through barter, but with indirect efforts at satisfaction of wants and consequent production for sale, it becomes extremely cumbersome and difficult to make exchanges by barter. It presents a number of difficulties which we have discussed in the opening chapter of the book, and barter outgrows its utility after a certain stage of economic development. With an elaborate system of division of labour, use of machinery, and large scale production, the problem of distributing the joint products and of distributing the products of the factory for world-wide consumption becomes all the more difficult and complicated without a sound mechanism of exchange. Hence, the necessity of a commodity of general acceptability and stability in value

to serve as a medium of exchange and a measure of value. Not only this, the production in anticipation of future demands and credit sales make it necessary that the standard of value must also be able to serve as a store of value and as a standard for deferred payments.

The problem of the standard therefore is the problem of determining what shall constitute the common denominator of all values or the standard of value to effect all sorts of transactions in any community. The commodity chosen to perform this function depends upon the stage of economic development of the community concerned and the range of incomes and scales of prices in it. But the problem of the standard of value is not solved by simply choosing by common consent a commodity to serve as a standard of value. The commodity chosen must be such as to maintain even justice and equity between the various contracting parties both in the present and in the future. That is to say, the commodity chosen to work as a standard of value must not only be universally acceptable but also should have stability in value, and durability because most of the dealings at present are in futures, the stability of the standard of value is not only desirable but an essential requisite, so that it may serve as a store of value and as a standard for deferred payment without inflicting

any substantial losses on the debtors and the creditors.

A sound monetary system or standard must satisfy the following conditions:—

- (a) It must have *stability*. The standard must be capable of maintaining so far as possible the stability of the internal prices and the balance of the internal economic structure on the one hand and the stability of foreign exchanges, on the other. So far it has not been possible to secure absolute stability of foreign exchanges and prices and it seems impossible to devise a system which can ensure such stability. However, violent fluctuations in prices and exchanges dislocate commerce and industry and should be avoided. Some economists are of the opinion that internal stability should be preferred to external stability. Our own view is that to a country of vast dimensions whose internal trade is more voluminous and of greater importance, stability of internal prices is more important than the stability of exchanges.
- (b) It must be *elastic* i.e., the media of exchange in circulation must be capable of expansion and contraction according to the needs of the business community. This can be

achieved when the currency and credit machineries are controlled by a central authority and there is a well-developed money and discount market

- (c) It must be *automatic in its operation* i.e. it must be free from government interference and manipulation. In a gold standard this is secured by maintaining a free gold market in which there is an automatic expansion or contraction of currency according to the movement of gold.
- (d) It must be *simple free from ambiguity and complexity* so that it is easily intelligible to the mass of people and inspired public confidence in the currency policy of the government. Moreover, it must be *economical in working* by avoiding unnecessarily huge quantities of metal in circulation or in reserves but economy should not be secured at the cost of efficiency.

Mono metallic or Bimetallic Standard —

This standard may be *Mono metallic* or *Bimetallic*. In a mono metallic standard coins of only one metal gold or silver are made principal or standard coins while those of others are token coins. In a bimetallic or double standard coins of both gold and silver are made standard coins and are unlimited legal tender. Mono metallism

therefore may be either a gold or a silver standard but in bimetallism both gold and silver enjoy free coinage, are unlimited legal tender, and standard coins

Beside these, there may be a *Paper Money Standard* in which there are no standard coins except tokens for making small payments and the paper tokens are unlimited legal tender and standard money. There is no conversion of notes into gold. Of late there has been an advocacy of an international and scientifically managed paper standard envisaging an international cooperation among the central banks of issue all over the world but it has not been favoured by a majority of the countries of the world on account of various reasons into a detailed discussion of which we need not go in this elementary treatise. At present many countries are on a Paper Standard and Gold vs Paper Standard is the leading problem of monetary theory and practice now a days.

Under the paper money standard the value of the unit of money is not tied to a commodity of high value in the world market as in case of gold standard and therefore there is no limit to the issue of money and possible fluctuations in value. Secondly, the paper money standard operates only within the limited area of a country and therefore that country is handicapped in international trade and finance.

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on account of wide fluctuations in the exchange rates.

Limping Standard —It is that phase of bi-metallism in which both gold and silver are declared legal tender, but both of them do not enjoy free coinage as they do in *pucca* bimetallism. Gold alone is freely coined, while silver enjoys a restricted coinage. It is also called "*Etalon Bouteux*".

Tabular or Index Number Standard —It is based upon the Index Number of commodities prices and aims at maintaining an evenhanded justice between debtors and creditors by securing stability in the value of money or general level of prices. It is essentially a standard for long term contracts or deferred payments which are to be regulated by officially kept Index Numbers the principals of the debts being increased according to the rise or fall in prices. It aims therefore at payments in goods and not in money. It is also called Multiple Standard because the Index Numbers are based on many commodities. It has been criticised very strongly by many eminent economists and is only of an academic interest.

The gold Standard has got three phases —

- (a) *The Gold Specie Standard or gold standard* with gold coins in active circulation. Under this phase gold is both a medium of exchange

and a measure of value Gold coins are unlimited legal tender and are freely accepted in settlement of transactions and payment of debts Currency or Bank notes are convertible on demand into gold coins, and the Government has an undertaking to buy and sell gold at a fixed price either for internal or external uses. The market for gold is free and its automatic working secures elasticity of currency and credit Before 1914, England and many other countries had this type of gold standard

- (b) *Gold Exchange Standard* —It is that phase of gold standard in which gold is a standard of value but not a medium of exchange Gold coins do not come into active circulation The Government is under no obligation to supply gold for internal purposes but has an undertaking to supply gold or gold exchange (i.e. a foreign bill of exchange on a foreign monetary centre having a gold standard) at its option at a fixed ratio in terms of the silver or paper tokens of the country for making payment to foreign countries For this purpose it has to keep a reserve in gold or foreign exchange

both inside and outside the country. The market for gold is not free, the system of currency and exchange is not automatic but managed and involves too much of Government interference and control. It was prevalent before the war in Java, Philippines, Mexico and Panama. The Indian gold exchange standard was a unique system.

- (c) *Gold Bullion Standard* —In this phase also gold is a measure of value but not a medium of exchange. Gold is not coined. However it is an improvement on the second phase in that the Government undertakes to supply gold for internal purposes also but only in a fixed quantity and as a fixed price. The internal currency consisting of silver and paper tokens is convertible into gold bullion at a fixed parity for internal or external purposes. The market for gold is free and there are no restrictions with regard to the object for which gold can be obtained from the Government. However, this is also a managed system of currency. Like the Gold Exchange Standard it aims at economising the use of gold by withdrawing it from circulation.

and keeping it only in reserve. It came very much into fashion in the post War period. England adopted it in 1925 and India in 1927. In both countries gold was obtainable only in bars of not less than 400 oz. It was a true gold standard because the value of the monetary unit of the country had a fixed value in terms of gold and was kept at equality with the value of a fixed quantity of gold and this is the essence of a true gold standard. It secured all the advantages of *pukka* gold standard and at the same time imposed upon it by economising the use of gold. It was automatic and simple and the market for gold was free.

Since 1931 gold standard has been abandoned by practically all countries including England and India which have sterling exchange standard now.

CHAPTER IX

BIMETALLISM

A system of currency in which coins of both gold and silver are standard coins and unlimited legal tender circulating at a fixed legal ratio between them and in which both the metals enjoy free coinage is called Bimetallism, or the Double Standard. The essentials of *pucca* or complete bimetallism, therefore, are free coinage of both gold and silver; unlimited legal tender characteristic of both gold and silver coins, and a fixed legal ratio between them.

In practice, however, it is very difficult to maintain the fixed legal ratio or mint ratio in conformity with the market ratio in which gold and silver exchange for each other like ordinary commodities. And this difficulty of maintaining a balance between the mint and the market ratio has been chief factor in discarding bimetallism. It is possible only when there is international co-operation and an international bimetallism. The divergence between the two ratios leads to the operation of the Gresham's law and the overvalued metal at the mint drives the undervalued from circulation. In practice, therefore, one metal forms the greater proportion of

the circulation of metallic money On account of this difficulty the free coinage of the cheaper metal is stopped although both of them continue to be unlimited legal tender. Then we have the phenomenon of *limping standard* which prevailed both in France and United States prior to the Great War of 1914-18

History The United States of America adopted bimetallism in 1792 at the ratio of 15 : 1 Later on when the market ratio became $15\frac{1}{2} : 1$ the over valued silver began to drive the undervalued gold from circulation This process continued till 1834 when the mint ratio was increased to 16 : 1 and this being higher than the market ratio gold which was overvalued at the mint began to drive silver out of circulation Then the gradual adoption of the gold standard by the countries of Europe and the discoveries of gold mines in California and Australia led to the discarding of silver Its price fell very heavily and in 1873 its free coinage was suspended although silver dollars remained unlimited legal tender Bimetallism thus ended in America

Bimetallism, however, had a more chequered history on the continent of Europe and especially in France which was the most important country of the Latin Union France, Italy, Belgium, Switzerland and Greece which formed the Latin Union practised bimetallism from the close of the

eighteenth century and continued to do so till 1873. On the reorganisation of her currency system in 1803 France adopted bimetallism at the ratio of 15 : 1, but on account of the erratic price of silver as a commodity in the market, there was a constant divergence between the mint and the market ratios, making some times gold and some times silver overvalued and displacing the other metal in circulation to the inconvenience of the government and the public. In reality the so-called double standard was an alternating standard because gold or silver formed the bulk of the money alternatively as the gold or the silver became over-valued and undervalued. Silver predominated upto 1850 after which the discoveries of gold mines changed the relative position of the two metals and gold became cheaper and displaced silver in circulation. Then was formed the Latin Monetary Union with France, Italy, Switzerland and Belgium with the avowed object of preventing the displacement of silver, Greece also joined it in 1868. Soon after the establishment of the Union the demand for gold increased on account of the surge towards gold mono-metallism and its supply could not keep pace with the increased monetary demand. On the other hand, the supply of silver at a time, when it was being demonetised and deposed from its place of pride practically all the world over, increased very much on account of

discoveries of silver mines in the United States. Naturally its price fell very heavily. The market ratio deviated very much from the mint ratio. Gold began to fly from France and silver began to be imported in larger quantities. The gradual but steady triumph of gold monometallism created a prejudice in favour of gold among the French public which disliked the disappearance of gold from the country. In 1874, therefore, the free coinage of silver was stopped by the Union, although the silver Five Franc pieces were still retained as complete legal tender. Thus, the double standard was replaced by a limping or incomplete bimetallism, in these countries also.

The great Depression which set in 1873 and enveloped the whole world in its grip provided an opportunity to the bimetallists to agitate for the rehabilitation of silver to its pristine glory and for the adoption of an international bimetallism as the only remedy against falling prices and the consequent losses to debtors, farmers, businessmen and unemployment. They claimed that the compensatory action of the double standard would steady prices. The increased demand of gold for money consequent upon the expanding trade, commerce and industry and its declining supply had led to the appreciation of the value of gold in terms of commodities and as silver had also been demonetised it had become an

ordinary commodity, and hence, its price in terms of gold like other commodities had also fallen. But the fall in price was not entirely due to the displacement of silver from circulation, the supply of silver had also increased on account of new mines and increased production. The mono metallists argued that if the demand of silver for monetary purposes would be created by adopting it side by side as standard money it would further stimulate production and the price of silver would not rise to its pre depression level. On the other hand, the bimetallists argued that bimetallism would lead to increased supply of money and would thus cause the prices to rise. An important International Conference was held in 1878 at Paris to canvass world opinion in favour of bimetallism but on account of the opposition of England and other gold standard countries it proved fruitless. Then another conference was organised at Brussels in 1892 but this also proved abortive. Towards the close of the nineteenth century Austria adopted a gold mono-metallism in 1892, India suspended free coinage of silver in 1893 and Russia and Japan adopted gold mono metallism in 1897 and U S A in 1900. In the meantime the discovery of gold mines in South Africa led to an evergrowing gold production and from 1895 prices had begun to rise. Thus, the two chief grounds for the revival of

bimetallism stressed by its advocates *viz*, inadequate gold supply for money and falling prices ceased to exist. Thus towards the close of the 19th century the fate of bimetallism was sealed for ever. It has now an historical and academic interest only.

Arguments for International Bimetallism or its Advantages *Stability of prices* Stability is one of the *sine qua non* of a sound monetary system. It is claimed that bimetallism provides a more stable standard and steadies prices. Prof Fisher says "Bimetallism is the only scheme for securing stability of the standard of value which has received any substantial measure of popular support. Bimetallism does this through its compensatory action, and through making the stock of money larger than under mono metallism. It is argued that historically speaking the production of silver was increasing at times when gold was decreasing or not increasing so rapidly, while, at other times, the production of gold was increasing when that of silver was decreasing or not increasing so rapidly. If therefore the two metals were tied together in a bimetallic system, these ups and downs tend to compensate each other. An increase or decrease in production of one metal would be counterbalanced by the decrease or increase in the supply of the other. This *compensatory action of the standard* would make it more stable in value

than would be the case under mono metallism. Prices, therefore, would be steadier. An historical evidence of it was furnished by France which was able through bimetalism to secure the steadiness of the mint and market ratio between gold and silver and the general level of prices after 1850. The demonetisation of silver and the triumph of gold monometallism from 1873 onwards at the time when the production of gold was not in harmony with its increased demand led to the fall in prices. But since 1890 on account of altered circumstances the introduction of bimetalism instead of steadying prices would have made them more unstable than they were under mono metallism. In the period after 1873 the adoption of bimetalism would have, by bringing silver to the aid of gold as a standard money, increased the supply of money and steadied prices by arresting their fall.

Then, the total stock of money when both gold and silver are used will be larger and any addition to the existing supply of money will not affect the value of money and the price level to the same extent as in mono metallism. Hence prices and the value of money would be steadier under bimetalism.

The scarcity of gold argument according to Dr Kemmerer is much weaker to day than it was a generation ago. The world's

gold production in 1897 was twice as large as the average of 5 years from 1885 to 1890. By 1915 the production of 1897 was doubled. For 19 years 1913 to 1932 the stock increased at an annual average rate of 4.8%, while for 16 years 1913-14 to 1929-30 the average annual rate of increase in the physical volume of world's production of basic commodities, according to the studies of Dr C. Synder, was 1.86%. In 1931 the world's production of gold was larger than in any previous year in history and in both 1932 and 1933 it was larger than in 1931. Then normally India absorbed about 25% of all the gold produced each year. Recently she has been pouring gold on world's gold markets out of her hoards at an annual rate of about 45% of total annual gold output. Furthermore, the economies effected, in the use of monetary gold in recent years by the adoption of the Bullion and the Exchange standards have been enormous. There is no evidence whatever that there is a shortage of gold. The present high value of gold and its scarcity are due to the hoarding of gold during the economic depression. The fourth Annual Report of the Bank of International Settlements estimated the total amount of gold in private hoards at the beginning of 1934 to have been at 7,000 m Swiss francs, or "more than two and a half times the value of the current annual gold production. As soon as we get out of this "slough of des-

pond" gold will be abundant. Therefore there is no need to supplement it by resort to bimetallism.

As regards the second argument, Dr Kemmerer has illustrated the compensatory action of the double standard by two drunken men walking arm-in-arm who would be steadier than either one of them walking alone. This "arm-in-arm drunken men" argument has lost much of its former weight in recent years because for most of the time since 1896 the values of gold and silver in terms of commodities have been moving in the same direction upto 1920 and a bimetallic tie-up would have dragged probably the value of gold down all the more faster, and from the middle of 1921 to 1929 the value of gold was more stable than that of silver.

Secondly, it is said that the stock of money under the double standard being larger the prices will rise and this will give an impetus to producers, farmers and business men by increasing their profits. The fall in prices and the consequent loss to the producers in the period of the Great Depression are cited in support of this contention.

Thirdly, it is claimed that bimetallism by raising prices benefits the debtors by reducing the burden of debt through the depreciation of the value of money.

Fourthly, bimetallism secures a stable

rate of exchange between silver and gold using countries, and therefore, helps foreign trade. By tying up the value of gold to that of silver at a fixed mint ratio the value of gold would be prevented from fluctuating materially in terms of silver, and likewise, the value of silver would be prevented from fluctuating in terms of gold. The foreign exchange rate therefore between gold standard and silver standard countries would be established as also between mono-metallic and bimetallic countries. Commerce between such countries would be freed from exchange uncertainties. Moreover a bimetallist country can carry on trade conveniently with both mono-metallistic and bimetallistic countries. Even this stability of exchange argument is of little consequence because no country is on a silver standard now. Under these circumstances bimetallism which could not stand the test of experience has become economically undesirable.

Arguments against bimetallism —Countries on the double standard have in reality only one money and that too bad money on account of the Gresham's law. The divergence between the legal ratio and the market ratio causes a good deal of confusion to the debtors and creditors. It leads to inflation of currency and this is unfair to the creditors, leads to speculation and demoralises the business community.

However, if national bimetallism is im-

practicable on account of the Gresham's law and the divergence between the market ratio and the mint ratio between gold and silver, it is possible to have an international bimetallism, in which case, through international co-operation, the compensatory action will effectively check the operation of the Gresham's law and maintain ratio between gold and silver

CHAPTER X

THE VALUE OF MONEY AND ITS DETERMINATION

The value of money means its general purchasing power that is to say its power of commanding goods and services in exchange. Changes in the value of money are measured by rise and fall in the general level of prices because money serves as a medium of exchange and as a measure of value. The value of all commodities is expressed in terms of money and as value means only a ratio or proportion in which things are exchanged for one another, therefore the value of money means the quantities of all commodities and services that are offered in exchange for money. The relation between the value of money and the general level of prices is an inverse one i. e. if the value of money rises the general level of prices falls if the value of money falls the general level of prices increases. *Every fluctuation in the value of money causes a proportionate inverse fluctuation in prices.* Changes in the value of money affect different classes of society in different ways and therefore their study is of great importance.

The value of money, like that of any

other commodity, is determined by its supply in relation to demand *It varies, other things being equal, inversely as its supply and directly as its demand* The supply of money consists of the total quantity of money and the rapidity of its circulation, while demand depends upon exchange work done by money It is true that an increase in supply will bring about a fall in the value of any commodity, and a decrease in supply will cause a rise in its value However, there is no uniform relation between the rise or fall in the value of these commodities and changes in their supply In other words, it is not essential that the rise or fall in values of these commodities is in uniform proportion to the increase or decrease in supply *e g* if the supply of ghee increases by 50% its price will not fall by 50% So is the case with iron, cotton, jute, wheat, and sugar etc But in case of money, it is said, that its value shall vary exactly in inverse proportion to its quantity in circulation For example, if the quantity of money in circulation is doubled, its value shall be halved, and if the quantity is halved, the value shall be doubled In other words, every change in the supply of money in circulation causes an inversely proportional change in its value Other things being equal, the value of money falls proportionately (and the price level rises) with an increase in the quantity of money, and the value of money rises proportionately

(and the price level falls) with a decrease in the quantity of money. This is called *the quantity theory of money* which explains how the value of money is determined. It is largely based upon the peculiarity of demand for money.

The Quantity Theory of Money

Enunciation The value of money under the simplest conditions varies exactly inversely to its quantity in circulation. In other words, "every change in the quantity of money in circulation other things being equal, produces a directly proportional change in prices." Or "the general level of prices varies inversely to the value of money and directly to the supply of money."

The phrase, 'other things being equal,' is very important, and comprises a number of assumptions under which alone the theory in its bald statement holds good, and these are (a) that the gold coins are the only forms of money in use, (b) that every piece of the gold coin changes hands as before or that there is no change in rapidity or velocity of circulation, (c) that there is no hoarding of coins or that money is used only for monetary purposes, (d) that there are no exchanges by barter, (e) that there are no credit instruments in circulation, and (f) that the rate of circulation of goods also remains the same as before the change in the quantity of

money in circulation. There is supposed to be no change in production, rate of consumption and population as well. *Thus stated, the theory holds good in a hypothetical society fulfilling these static conditions.* It is not in accord with the actual facts of life and to make it so accord with, allowance must be made for the following (a) velocity or rapidity of circulation of metallic money, (b) rapidity of circulation of goods, (c) exchanges by barter, (d) use of cheques, bills, promissory notes, bank notes, shares, stocks, bonds, and scripts etc, which although not money perform the functions of money, and (e) the velocity of circulation of credit money i. e., bank deposits, cheques, bills etc.

After making due allowance for these factors the theory may be enunciated as follows: "*The general level of prices tends to vary directly in proportion with the quantity of money in circulation and its rapidity (i.e., its supply) and inversely with the activity of exchange (i.e., the demand for money) indicated by the number of gold exchange multiplied by their prices*" In other words, the value of money like that of an ordinary commodity is determined by the conditions of demand for money and its supply. *Every fluctuation in the quantity of money causes a directly proportionate change in prices.*

In its original form the theory is expres-

sed mathematically in the form of an equation having a goods side and a money-side as $P = \frac{M}{T}$. This equation does not take account of the velocity of circulation of the coins. If we take into consideration the rapidity of circulation of metallic money then the equation will be $P = \frac{MV}{T}$ or $PT = MV$. But to make it accord with the modern conditions of life, Prof. Irving Fisher has stated it now as $P1 = MV + M'V$ or $P = \frac{MV + M'V}{T}$

In this equation PT is the goods side and $MV + M'V$ is the money side. P stands for the prices of goods exchanged for money and T for the total volume of trade transactions, M for the quantity of metallic money in circulation and V for its velocity of circulation, M' for the quantity of credit money in circulation and V' for its velocity of circulation. *Prof. Fisher concludes that the price level changes directly in proportion to M , directly in proportion to V , directly in proportion to M' , and directly in proportion to V' , and inversely with T . The first four of these constitute the quantity theory of money.* He further asserts that P or the general price level is the result and the other factors in the equation are the causes.

Properly qualified and understood the theory, in spite of its criticism, holds good. In the provisional statement of the theory in the first equation an account is taken

only of metallic money in circulation. But the quantity of effective money in circulation comprises not only the number of coins but also the number of times that they change hands in the settlement of transactions or their velocity of circulation. The total quantity of money in circulation multiplied by its velocity gives the total quantity of effective money in circulation. The effect of an increase in the velocity of circulation of money is the same on its value as the effect of an increase in its quantity. For example, if hundred coins are utilised in exchange and every coin changes hands twenty times in a day then these 100 coins are doing the work of 2,000 coins, because every time that a coin changes hands it does the work of a fresh coin. This frequency or rapidity with which a coin changes hands is called the velocity of its circulation. Now if the rapidity of circulation of the coins is decreased to 15 they will do the work of only 1500 coins and the effect will be the same as if the quantity of money in circulation has decreased by 500. If it is increased to 30 then coins will do the work of 3 000 coins. That is why the quantity of effective money in circulation is obtained by multiplying the quantity of coins put in circulation by their rapidity of circulation. But these days not only metallic money but government and bank notes also play a very important part in the settlement of transac-

tions and debts and they are made legal tender Hence, we take into consideration both coins and notes as well as their velocity of circulation In actual practice, however, a majority of the day-to day transactions are settled through the instrumentality of credit and its concomitants These days the greater proportions of trade transactions are settled by bills of exchange, cheques, promissory notes etc and they change hands several times before they are liquidated Hence, to complete the monetary side of the equation we must take into consideration the quantity of credit money and its rapidity of circulation in order to arrive at the total quantity of effective money in circulation On the commodity or the goods side of the equation only such quantities of various commodities together with their prices are taken into consideration as are exchanged either for cash or credit money All transactions effected through barter are ignored When the total volume of goods exchanged is multiplied by the prices at which the various commodities are purchased the goods side is equal to the money side *i.e.* $PT =$

$$M \cdot FV + M \cdot V$$

Still, the quantity theory of money has been vehemently criticised as an abstract doctrine It is very difficult to determine at any period of time the exact quantity of various kinds of money in circulation and therefore the value of money

changes in it can be measured only roughly and at best they depend on estimates and averages. The only method of measuring the changes in the value of money is to prepare index numbers of prices which are in themselves based on estimates and averages. In spite of various criticisms offered against the theory, Prof Fisher holds fast to it and advocates it as the only method of determining changes in the value of money.

Criticism

It is pointed out that transactions are still carried on by barter and, therefore, the total volume of transactions that is taken account of in the equation of the theory falls short by that quantity, that it does not hold good except under certain hypothetical conditions, that it is simply a self-evident fact or a truism, and that the value of money is not only affected by its quantity in circulation but also by its demand, but the quantity theory lays undue emphasis on the supply side and therefore it is *imperfect*.

The theory simply says that General Price Level = $\frac{\text{Quantity of Money exchanged for Goods}}{\text{Quantity of goods exchanged for Money}}$. But even if it is taken as a truism only, it does more than simply telling that $P = \frac{MV}{T}$. It explains the results of a change in the velocity of circulation

of money, the effects of new discoveries of gold, the effects of a contraction of currency and credit and the effects of huge issue of paper money and increased output of goods due to improved methods of production

Prof Knapp's Criticism—In his treatise 'The State Theory of Money' Prof Knapp contends that the value of money is not the result of its intrinsic worth as a commodity but the State action in declaring it as legal tender and therefore the theory of demand and supply as determining the value of money like that of an ordinary commodity is not applicable to money True it is that the major portions of the media of circulation in any country in the modern times consist mostly of notes, deposit currency and instruments of credit but still they are based on a certain metallic reserve And to that extent the cost of production of gold and silver mines will have an effect on the quantity of money in circulation and consequently on the value of money

John Stuart Mill's criticism—Mill takes an exception to the heterogeneous character of the terms in the Equation of Exchange and contends that the amount of cheques in circulation cannot be added to the amount of gold in circulation any more than 20% can be added to £100 When credit comes to play an important part

in transactions the relation between prices and the amount of the circulating media is much less direct and intimate and the relation that exists does not admit of so simple a mode of expression as the Equation of Exchange implies¹

Prof Cannan's criticism—Money is not governed by the strict law of supply and demand "The demand for currency is furnished not by the number and amount of transactions not by the ability and willingness of persons to hold currency, in the same way as we think of the demand for houses as coming not from the persons who buy and resell or lease and sub-lease houses but from the persons who occupy houses"

Another criticism of the quantity theory of money is that it cannot explain the rise or fall in prices in one country without reference to prices all over the world

Prof Fisher, who is the most unyielding advocate of the theory, however, maintains that the theory, if properly understood and suitably modified to make allowance for the prevalence of credit, velocity of circulation and velocity of goods, does explain the rise and fall in the value of money. What is difficult and arbitrary, and to some extent unreal, is the mode of measuring the changes in the value of money

¹*Political Economy*.

with the help of Index Numbers. He therefore, insists that $P = \frac{MV + MV}{T}$. He defends the theory strongly and in his scheme for "Unshrinkable Dollar" he shows how stabilisation of currency can be effected by the Quantity Theory of Money.

By regulating the supply of money in circulation, we can control the general price level. The Quantity Theory of Money and its relation with the general level of prices is very closely established when we regulate prices for lowering or raising or stabilising them by controlling the working of gold and silver mines (as in 1892), by controlling mintage to regulate the amount of gold in circulation (The Scandinavian Experiment, during the Great War), by varying the standard of value without changing the name (Fisher's Compensated Dollar Scheme), controlling the circulation of bank or government notes (Post-war Monetary stabilisation) by regulating the circulation of cheques and other instruments of credit, by fixing the proportions of banking reserves, by encouraging an increase in the volume of trade by increased money. In spite of its criticisms, therefore, the Quantity Theory of Money is very important and contains an element of truth in it.

CHAPTER XI

CHANGES IN THE VALUE OF MONEY

Inflation, Deflation and Reflation

Changes in the value of money are not uniform and they do not affect the various classes of society uniformly. A rise in the general level of prices or a fall in the value of money does not register an all round upward trend in the prices of all commodities while the prices of some goods rise of others remain stationary, and the prices of still others fall. Thus, the rise or fall is not uniform and therefore, the economic consequences of this rise or fall will not be the same for all. When prices rise (Depreciation of money) other things being equal traders and businessmen gain. Profits rents and interest usually go up. But the rise in rent and interest as also in wages usually takes a longer time and they lag behind prices. The rise in prices is of advantage to debtors and of disadvantage to creditors because in terms of commodities the debtors return less to the creditors in the payment of instalment of the principal and interest thereon. Enterprisers as debtors benefit by the fall in the value of money. The tax-payer also gains as a debtor to the

State, and the burden of the national debt decreases. Creditors, consumers and people with fixed incomes on the other hand, lose in period of rising prices. Moreover, a rise in prices leading to abnormal profits causes excessive speculation, demoralises the business classes and the investing classes and culminates in crises. These evils are intensified by large and rapid rise in prices. Moderate and slowly rising prices are of advantage to producers and labourers because they stimulate steady and increased employment and production. The economic gains and losses from rapid changes in price will, therefore, differ according to the economic strength of the different classes in the community.

When prices fall (Appreciation of money) their effects are just the reverse. Creditors gain and debtors lose in terms of commodities. Trade and business become dull, profits decline and, if the fall in prices is rapid and lasts long, interest and rents also decline. A large and serious fall in prices discourages production and increases unemployment and both capitalists and labourers suffer. Tax-payers also suffer and the burden of the national debt increases. Persons with fixed incomes gain as also do the labourers.

Besides these effects of a rise or fall in prices on the different classes of society in general, their effect on Government fin-

ances are also noteworthy. In a period of rising prices business and production being brisk tax revenue is larger and budget is not only balanced but shows surpluses. On the other hand, in a period of falling prices there is an economic depression and the Government revenue goes down deficits in the budgets occur unemployment prevails and relief works have to be organised to mitigate the evils by raising loans for short terms. But to this dark side of the picture there is one relieving feature so far as the Government finance is concerned, and that is the possibility of a reduction in debt burden by conversion of loans raised formerly on high rates of interest into new loans at lower rates.

Besides these serious economic consequences changes in the value of money have far reaching social effects. Constant fluctuations in prices disturb the stability of production trade and employment and this instability causes a good deal of social distress. In a period of rising prices, the cost of living increases and labourers are in trouble. They agitate for increased wages and organise strikes. This disturbs public peace and causes social unrest. Falling prices lead to reduction and wage cuts, retrenchment and economy and thus many people are axed and lose their jobs. There is again conflict between labour and capital and lockout and strikes. Social unrest and unemployment increase and intensify.

It is, therefore, the extreme diversity in the effect of the changes in the value of money on the various classes which makes a study of the causes and extent of these changes necessary and a matter of paramount importance. A periodical comparison of price movements throws considerable light on the economic conditions of the various classes and indicates the rise or fall in standard of their comforts.

One of the most remarkable features of currency, exchange and finance during and after the World War has been the enormous changes in the value of money caused by experiments in monetary policies with a view to the maintenance of the stability of the foreign exchanges and the stability of the internal prices. The most potent factors for these remarkable changes have been unprecedented expansion and contraction of currency and credit commonly known as inflation and deflation.

Inflation

When an expansion of currency and credit takes place without a corresponding extension of trade and commerce it is said to be inflation. Inflation exists in a country whenever the supply of money and of bank deposits circulating through cheques increases relatively to the demand for the media of exchange in such a way as to bring about a rise in the general price level. The sup

ply of money and credit must always be interpreted in terms of their respective velocities of circulation. Inflation causes a reduction or depreciation in the value of money, because on account of rise in prices, its purchasing power is diminished. It is a deliberate act on the part of the currency authority and is usually resorted to when the credit or the Government is too low, and there is loss of public confidence in its financial and economic policy so that loans cannot be raised either internally or externally except on exorbitant or high rates of interest. Usually the *main objects and aims of inflation* are (1) to avoid the impact of heavy debt burden and (2) to raise the internal price level as compared to the world price level in order to give encouragement to the nascent industries of a country.

The first object of inflation is achieved by various devices and dubious means to lower the value of bonds and securities, and to reduce in this way and shift the pressure of loans, and to substitute new loans or indirect repudiation of old debts by depreciating the value of money instead of raising taxes to tide over the financial difficulties of the Government. The desire not to face the consequences of a heavy debt burden leads to uncertainty and delay in decision which leads to a soft money policy ending in the long run in inflation of currency. In this way inflation by reducing artificially

the value of Government securities leads indirectly to the imposition of a capital levy because it diminishes the value of all savings and investments. It destroys indirectly national wealth of the country and leads to a loss of public confidence in the currency and exchange policy. The normal processes of production and consumption are disturbed and economic enterprise becomes unsound and speculative. This is inevitably followed by deflation or devaluation the first of which causes an acute trade depression by curtailing the quantities of money and credit in circulation, puts a severe strain on Government finances by reducing the tax revenues and by necessitating the raising of short term loans to wipe off the deficits in the budget, and to provide a relief to the unemployed by opening reconstruction works, and finally ends in unexpected obligations of the Government both at home and abroad.

In the second case when industry, trade and business are suffering from an acute depression and heavy fall in prices, in order to give a spurt to them the Government artificially raises the price level by a deliberate expansion of currency and credit. This has been the chief object of the American inflationary policy in the Post Depression Period from 1932 onwards.

For the discussion of the effects of inflation on distribution of wealth in various

classes of society Mr J M Keynes in his "A Tract on Monetary Reform" has divided the society into three broad classes

- (a) The investing class
- (b) The business community
- (c) The wage earning class

In these days of dealings in futures the stability in the value of money is a matter of very great importance, because long period contracts for the lending and borrowing of money result in disturbance of the relationship between debtors and creditors, if the value of money changes frequently and violently between the lending of money and its repayment. We have already seen that the changes in the value of money or the general prices affect the debtors and creditors differently. In a period of rising prices debtors benefit and creditors lose, whereas in that of falling prices creditors gain and debtors lose. If there is stability in the value of money over long periods of time, such violent disturbances to debtors and creditors are avoided. Inflation by causing firstly a gradual rise in prices leads to a rapid increase in prices and then to panic and speculation, and therefore demoralizes the market for capital. In such conditions it becomes difficult to forecast the probable demand for the future for various commodities, a discount is put on economic enterprise, and trade and business, therefore, become speculative ventures.

In the beginning and the middle, on account of the heavy rise in prices, business activity is very brisk and rapid, turn-overs are quick and profits like prices soar very high. This industrial boom leads to a very great demand for capital, and prices of ordinary shares and capital goods rise, borrowers at fixed interest gain and lenders lose. Eventually it is followed by an inevitable crash and ends, therefore, in disaster. Thus, we find that in a period of inflation and rising prices, the demand for capital goods is accelerated and, their prices, and dividends on bonds and shares, rise. But on account of rise in prices, their real income in terms of goods declines and therefore inflation is injurious to investors receiving fixed money by way of interest and rent.

The business community gains enormously during inflation and rising prices. People are caught by the mania of growing rich quickly. Optimism sways the land and all sorts of enterprises are started, company flotations increase in number and a mushroom growth of factories and business takes place. This feverish activity in the sphere of production leads to brisk trade, quick turn overs and profits multiply fast. For example, during the War when only fifteen rupees per share had been paid on the shares of Tata Iron Co. Ltd., the shares were selling in the market at a premium of 500%. The same was the

case in shares of other well established concerns. The abnormal rise in prices leads to wind-fall profits and encourages therefore industrial enterprise. But if inflation is carried to a very great extent so as to result in a premium on gold and foreign exchanges, the imports into the country, that has resorted to inflation, begin to increase, provided however, that there is not concurrent inflation in other countries as well. In this case, therefore, the internal price level being higher than the world price level, it becomes more profitable to sell to, than to purchase from, the inflationary country. Exports, therefore, tend to decline. Imports increase and the balance of trade becomes unfavourable on account of the dumping of the foreign goods, if it has a free trade market. Then the boom is followed by a depression, inflation by deflation and a rise in prices by fall in prices generally. The profits of the inflationary period give place to serious losses and the rapid flotation of concerns and companies is followed by bankruptcies and, therefore, many companies and concerns drop out like leaves from the trees in autumn. There is chaos, budgetary deficits, financial embarrassments and a reduction of the national wealth all round. Deflation, therefore, ushers in a period of depression and acute unemployment. The finances of the Government become disorganized, revenue declines, relief mea-

asures have to be undertaken which are financed by heavy short term borrowing both inside and outside the country. Thus it hits the business very hard.

As regards wage-earners and people with fixed incomes they suffer great hardships in a period of inflation because of abnormal rises in prices. Their cost of living increases because every unit of the income purchases a less quantity of commodities and services and hence real wages decline. The situation is further aggravated on account of the economic friction *i.e.*, the wages lagging behind prices. Nominal wages do not increase as fast as prices rise and, therefore, all people with fixed incomes suffer. Contrariwise, in a period of deflation when prices fall, this class of people gains because every unit of income now purchases a larger quantity of commodities and services.

Deflation

Whenever the supply of money and of deposit currency decreases relatively to the demand for them in such a way as to cause a decline in the general price-level, there is said to be a deflation or contraction of currency. It leads to a fall in prices and therefore to a rise in the value of money or increase in its purchasing power which is called *Appreciation of money*. The effects of Deflation and Appreciation of money are just the reverse of those of Inflation.

and Depreciation of money and they have been described above

Of these two (inflation and deflation) deflation is condemned very strongly by all distinguished economists of the world because of its far-reaching and undesirable social and economic effects: discouragement of enterprise and production, diminution of trade and employment, and increased burden of national debts of all kinds. It generally benefits non producers or rentiers at the expense of the real producers of wealth. 'Inflation redistributes wealth in a manner very injurious to the investor, beneficial to the businessman, and probably, in modern industrial conditions, beneficial on the whole to the earner (wage-earner). Of the two perhaps Deflation is, if we rule out exaggerated inflations such as that of Germany, the worse, because it is worse in an impoverished world, to provoke unemployment than to disappoint the rentier' ¹

Stability of prices, therefore, should be the chief aim of the currency authority to avoid the uncertainties and losses which large changes in prices inflict on the creditors and debtors, entrepreneurs and wage earners, consumers and producers. It reduces extreme inequalities of income and wealth in society, maintains equity and justice between creditors and debtors,

through the steadiness of prices makes for stability in production, trade employment and general business conditions, and prevents social unrest and heart burnings between employers and employees, capitalists and labourers and creditors and debtors

Reflation means a deliberate inflation or deflation of currency with a view to restore the price level existing before such inflation or deflation. During the period of the recent world-wide economic depression when prices of primary products and raw-materials had fallen by more than 50% and farmers and primary producers were suffering very heavy losses, the word was coined in the United States of America, and therefore, it meant at that time an expansion in the supply of media of circulation (inflation) with the intention of raising prices to restore the price-level existing before the era of the depression. It is a recognition of the principle that by a judicious control the manipulation of the quantity of money in circulation together with Bank deposits and cheques the currency authority can control and regulate the movement of prices to avoid violent fluctuations with all their concomitant evils.

CHAPTER XII

INDEX NUMBER

We have seen above that prices do not rise or fall uniformly. If all prices went up and down together, the measurement of the changes in the value of money or the general level of prices would be easy. But this they never do. Some prices go up, while others go down. Occasionally, however, in times of very great and rapid movements almost all prices change in the same direction. Even then some rise or fall in less degree than others. This complexity of the phenomenon of prices makes difficult the measurement of its extent. The method of Index Number is resorted to to get a summary expression of the general trend of prices, or, changes in prices or value of money are measured by Index Numbers. Index Number, as the word index implies, indicates a general rise or fall in prices. In other words, the index numbers serve to point to a fact that *on the whole* prices have moved in one direction. They no more than indicate a general tendency. In the words of *Prof Taussig*, "No index number corresponds to the real thing. It is not like the mean of certain observations in natural science whose average will

point to a single special fact. This is to repeat only an indication of the general trend of prices. There is no one change in prices, there is a medley of many changes, different in direction and degree. All that we can hope to secure by averaging and summarising is some concise statement of the general drift."¹

Index numbers are usually of two kinds Simple and Weighted. The modes of reaching numbers are four —(1) Simple Arithmetic Mean or Weighted Arithmetic Mean (2) Geometric Mean (3) The Median, in which there is no averaging but only an ascertainment of midway points or the figure which stands in the middle of the series, and (4) the Mode

Preparation of Index Number —A few representative commodities relevant to the object in view are selected their prices for a particular year or period are noted, and these are reduced to hundred and an arithmetic mean of these is drawn up. Later prices of the same commodities are then expressed in relation to them (*i.e.*, the prices of the base year or period) usually by stating them in terms of a percentage. The arithmetic mean or average of these prices in later periods or years is also taken out and then, a comparison is made in terms of a percentage rise or fall which is called the price index number. This is the

¹Principles of Economics

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way of preparing simple index number. Let us illustrate it by a concrete example :—

Suppose that in September, 1931 in England the price of Wheat per qr. was 23s 9d., of Butter 128s. per cwt.; Cotton 3 80d. per lb, Coal 31s. 4d. and Pig iron 58s. 6d. per ton and in April 1935, the price of wheat had risen to 33s. 4d. that of butter had fallen to 106s., of cotton risen to 6 53d., of coal fallen to 29s 8d. and of pig iron risen to 70s. The index number will be prepared as follows—

	Sep 1931		April, 1935	
	Base price	100	Price	Percentage to Base
Wheat	23s 9d	100	33s 4d	140
Butter	128s	100	106s.	83
Cotton	3 80d.	100	6 53d	172
Coal	31s 4d	100	29s 8d	95
Pig Iron	58s 6d	100	70s.	120
Total ..				
Average (Arithmetic mean)	Old Index Number	$\frac{500}{5/500}$ 100	New Index Number	$\frac{610}{5/610}$ 122

This shows that on the whole the general level of prices had increased from 100 in 1931 to 122 in April 1936; *e.*, there was on the whole an increase of 22% in the general price level. Or, it can be said that what could be bought of these commodities for 100 units of money in September 1931, could be bought for 122 units in April, 1936. Therefore the value of money had fallen by 22%.

Sometimes, however, the relative importance of different commodities of consumption is also taken into consideration in order to get the index number. This relative importance of different commodities is expressed by assigning to them a certain *weight* in proportion to their consumption. For example, if the consumption of wheat is five times as great as that of cotton and of butter four times as great then wheat and butter shall be counted as equal to five and four commodities respectively. Index number obtained in this way is supposed to give a better result than the simple arithmetic average. But the preparation of the weighted index number presents a number of *difficulties* *e.g.*, it is impossible to determine exactly the economic importance of a commodity in the life of a community or people, *secondly*, the effect of fashion, custom and habits on the demand for commodities is rather sporadic and violent, *thirdly*, the changes in the value of money due to a contraction or expansion of the supply of specie

also have their effect on the relative demand for commodities. Hence, we can conclude without any fear of contradiction that if the number of articles selected is sufficiently large and representative in character the result obtained from the simple index number is quite sound for the purpose and does not show a great discrepancy between the result obtained from the other and more complicated methods.

Thus according to the weight index number the price level on the whole shows an increase of 23.86% instead of 22% as revealed by the Simple Index Number.

WEIGHTED INDEX NUMBER

If we assign due weight to the various commodities according to their economic importance in the community then the index number will be as follows.—

INDEX NUMBER

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	September 1931			April 1936		
	Weight	Base Price	Weighted Base	Price	Percentage to Base	Weighted change in Price
Wheat ...	5	23s 9d.	500	33s. 4d	140	700
Butter ...	4	128s.	400	106s	83	332
Cotton ...	3	3 80d.	300	6 53d	172	516
Coal ...	2	31s. 4d	200	29s. 8d	95	190
Pig Iron ...	1	58s 6d.	100	70s.	120	120
Total ...	15		1500			1858
Average ..		Old Index Number	100		New Index Number	123 86

Precautions necessary while preparing an index number

First of all a great care should be taken in selecting the base year of period. It must be free from abnormality of any sort like war, financial or trade crisis, failure of crops or floods, famines, bumper harvests or from any monetary disturbance. *Secondly*, a great care should be taken in selecting the commodities which must be suitable for the purpose in view. If cost of living or labour index numbers are to be prepared, the commodities that are selected must be such as are consumed by the majority of the labouring class, whereas if we want to find out the effect of rising or falling prices on the community in general, then we will have to include a host of other commodities than those consumed by labourers alone. *Thirdly*, care has to be taken in the selection of the price as well, i.e., whether the prices are wholesale or retail because the selection of these shall depend upon the purpose in view. If we have to prepare cost of living index numbers, we shall take into account retail prices and not wholesale. It is very difficult to get reliable figures of retail prices which do not necessarily move in conformity with wholesale prices. *Fourthly*, the number of the commodities chosen will also determine the reliability of the index number. To give an accurate idea of the trend in prices the number of the com-

modities included must be as large as possible *Fifthly*, the economic and social importance of the various commodities of consumption should also be taken into consideration *Sixthly*, the averaging of the price ratios must be done judiciously

The most authoritative index numbers in England are those of Saurbecks, the 'Economist' and the 'Statist', in India, on the other hand, the two important index numbers are those of Calcutta relating to wholesale prices, and of Bombay prepared by the Ministry of Labour and relating to the cost of living of the labourers

If the selection of the base year or period and of representative commodities relevant to the purpose in view and the collection and sifting of prices and preparation of averages are done properly with due discrimination, then Index numbers yield a sufficiently reliable information about the rise and fall in prices and the fall or rise in the value of money At best, however, they are only averages and do not measure the changes in the value of money accurately and precisely In fact it is not only difficult but impossible to measure the changes in the value of money accurately. 'a perfectly exact measure of purchasing power is not only unattainable but even unthinkable'²

Even if the index numbers at their best

indicate only a general trend of the price movements, they are very useful to the economist, to the businessman, to the politician and the statesman. They are very helpful to the student of economics to verify his conclusions and inferences as regards the effects of price changes on the economic welfare and standard of living of different classes in society and provide a basis for comparative study of these things to the student of economic history. The rise and fall in wages and their purchasing power together with rise and fall of interest with their effects on capital within the same country from time to time and between different countries at different periods can be found out with the help of index numbers. They provide a basis for the regulation of quantity of money in circulation to maintain stability and prices in trade. The businessman can compare from time to time the progress of his business and the trend of interest, profit and turnover not only in his own business but also in others. Adjustment of wages can be done with their help to settle wage-disputes between the employers and the employees. They furnish a basis for the equitable discharge of long-term debts and for determining the real incidence of taxes. Thus, they are very useful in roughly measuring the changes in the value of money from time to time and their effects on various classes and on different countries.

CHAPTER XIII

GOLD STANDARD

The development of trade, commerce and industries on sound lines pre-supposes the existence of 'an integrated price and income-structure and stability of internal price-level and foreign exchanges. Prior to the Great War, the world has succeeded in evolving a system of international currency which was freely automatic in its operation and was fairly stable for about a century except for occasional disturbances. This international mechanism, based on integrated price and income structure was the Gold Standard.

Gold Standard is a monetary system in which the unit of value, in which prices and wages are customarily expressed and in which debts are usually contracted, consists of the value of a fixed quantity of gold in a free gold market.¹

A Historical Resume Triumph of the Gold Standard —The gold standard is essentially a creation of the second half of the nineteenth century. At the close of the Napoleonic wars the currency systems of the world were largely based upon silver

¹ *Kemmerer* On Money

alone or on gold and silver in combination Bimetallism *i.e.*, a system of currency in which both gold and silver circulated together with a fixed legalised ratio between them was in vogue That system has been given up since as a result of conviction impressed upon one country after another that gold and silver cannot be kept in concrete circulation in an arbitrarily established mint ratio England was one of the first countries to arrive at this conclusion and led the way by establishing gold standard in 1816 In the continent of Europe however the struggle to maintain the double standard was continued until the third quarter of the last century From 1803 to 1823 France etc succeeded in keeping both gold and silver in circulation at their established mint ratio of 1 15½ Thereafter several circumstances combined to compel these countries to give up this policy Chief among these causes was the increased supply of silver due to the discoveries of mines in America which lowered the value of the metal and caused its substitution on large scale for the dearer gold coin Seeing their gold coins disappearing from circulation and fearing that they would be brought to a cheaper standard they decided to limit the exchange of silver and in 1818 to close their mints altogether to the free coinage of that metal By this action they maintained their dearer standard which was thenceforth gold Then

in 1848 and 1859 the gold discoveries in Australia and California in hitherto unknown quantities, leading to a period of rising prices, brought about the adoption of the gold standard by other countries. In 1865-66 the Latin Union consisting of France, Italy, Switzerland and Belgium was formed to prevent the disappearance of silver coins and Greece joined them later on. The gold standard became so popular that Germany, which by 1823 had adopted the single gold standard by limiting the coinage of silver, after the Franco Prussian War of 1870, celebrated her victory by deserting silver completely and adopting gold as the basis of her currency. Other countries like Holland, Norway, Sweden and Denmark followed her example. Production of gold lagged behind its demand, there was a swing of the pendulum, a long sustained period of falling prices ensued in 1873 which enveloped the world into the Great Depression. A number of international conferences were held and the advocates of bimetallism gained the ear of the world. But the gold standard countries led by England stood fast by the gold standard, the international conferences proved abortive and after 1877 the fate of bimetallism or the double standard was sealed and gradually but steadily there was an almost universal transition from the silver or mixed currency system to gold mono-metallism. The discovery of fresh

gold mines in Transvaal knocked the bottom out of the bimetallists' arguments, righted the position, and a period of rising prices and brisk trade followed which continued unabated till 1914. Even Austria-Hungary and Russia which for several years had depreciated paper currency as the chief medium of exchange accumulated sufficient gold to establish securely the gold standard. Thus, at the end of the 19th century all important countries except Spain had the gold standard in actual operation. Outside Europe a similar development was in progress during the same period. Thus, silver was demonetised in all the important countries of the world except India and China and a few minor countries between 1848 and 1914.

Causes of Triumph — This triumph of the gold standard was due in the main to its comparative stability and freedom from violent fluctuations of prices and exchanges. In spite of its casual side slips, as in the Great Depression, the gold standard had spelt the material progress of the world. Even Mr J. M. Keynes, the keenest and the most effective critic of the gold standard has admitted that, wide as were the fluctuations in prices, the remarkable feature of the period between 1815 and 1914 was the relative stability of the price-level, and as Mr Hartley Withers says in his "Money in the Melting Pot" approximately the same level of price ruled in or about the

year 1826, 1841, 1855, 1862, 1867, 1871 and 1915, and prices were also level in the years 1844, 1881, 1914 and in 1931

For about three generations before 1914 the world passed through a period of comparative peace and growing prosperity. The effects of war, financial crises and economic depression were kept within bounds and the curve of prosperity through occasional side slips was a rising one. The fundamental principles of modern economic society—division of labour, private property and free and voluntary exchange with a unit of value and a medium of exchange had laid firm hold on the peoples of the world, the obstacles to international trade had been removed by the eliminations of customs frontiers and private privileges, the remarkable development and improvement of all the means of communication and transport had closely knit the whole world into one economic unit. Tariffs were moderate, and the "chauvinist" was slow to stray outside the spheres of politics. Great Britain, the greatest creditor nation of these days, through the Bank of England and the London Money Market—the hum of the business world—backed by the industrial power and financial strength of England was investing freely, steadily and methodically her favourable balances in the newer and younger countries for reproductive development and equipment in her own Dominions in Cana

da, Australia, New Zealand and South Africa, in India, in N and S. America, in Russia and in the Far East Railways, ports, and docks, canals and mines, plantations and industrial ventures were freely financed. In this admirable task of international lending, she was ably seconded by France and to a smaller extent by Germany, Holland, Switzerland Belgium and the Scandinavian countries. Thus, goods and services worth £300 m to £400 m every year found their way through a wide and free international loan market into the borrowing countries from the lenders. The world trade as a result of all these things was progressing steadily.

This complex structure of international credit and vast amount of foreign investments would have been impracticable but for the delicate mechanism of the gold standard on the monetary side evolved during the nineteenth century. The two main considerations for the successful operations of this international loan market were the stability of exchanges and the stability of internal prices. By fixing the value of the unit of account of each civilised country in terms of gold the world had contrived to maintain relative stability of exchanges and similar movement of price levels in all the gold standard countries of the world. This relative stability of exchange created confidence in the investors and the practical working of the gold standard became

more or less automatic Thus, the international gold standard became a mere, "device of securing fixity of exchange rates and maintaining an integrated price and income structure over the whole range of gold standard countries"²

Phases of gold standard —The gold standard, as it has developed during the last hundred years or so, has three forms —1 *The Gold Specie or Currency Standard* based on the free coinage of gold and the use of gold in the form of coin as a medium of exchange 2 *The Gold Exchange Standard* based on the convertibility of the currency into a foreign currency which is itself preserved at parity with gold 3 *The Gold Bullion Standard* depending on the obligation of the Central Bank of Issue to buy and sell gold bullion without restriction at a fixed price and in a fixed quantity, and thus securing the free convertibility of gold into credit and credit into gold and preventing adequately the demand for gold for internal circulation

Pre War Gold Standard

The Gold Specie Standard Features —The gold standard upto the Great War of 1914 was a *specie standard* in which gold was the standard of value in all the countries of the world and a medium of exchange in

²T E Gregory, Gold standard—Past Present and Future

all countries except India and China etc. Coins of gold were standard coins and unlimited legal tender, they enjoyed free and unrestricted coinage. The value of the gold coin as money and its value as bullion was more or less the same, and the rate of exchange between two gold using countries differed from the mint par of exchange between the specie or gold points and was regulated through the maintenance of a free market for gold. The working of the system was perfectly automatic in as much as no restriction was put on the flow of gold from or into a country. The free international market for gold, therefore, and its free movement prevented gold from accumulating in embarrassing quantities in any one country at the expense of the other. An inflow of gold leading to plethora of funds caused the internal price structure to rise above the world price-level and, therefore, caused the rate of exchange to rise which encouraged imports and discouraged exports and thus regulated the rate of exchange through the balance of indebtedness. An outflow of gold from a country had the reverse effect. Another important feature of the pre-war gold standard was the ready convertibility of currency notes and Bank notes into gold coins on demand which not only saved the gold coins from wear and tear but also economised their use. The coins of other metals had a restricted coinage and were, therefore, mere tokens enjoying

limited legal tender quality.

Merits.—The standard secured *fixity of exchange* which was a great boon to trade, industry and commerce. *It ensured that the price and income structure of a country will not be out of tune with international price movements. It prevented the currency authority from taking arbitrary action which is possible under a managed system of currency. It necessitated an international co-operation for its maintenance, and inspired public confidence.* The investing public had pinned its faith to gold. It had implicit faith in *its stability and permanency*. The chief cause of their faith in the system lay in the *relative freedom from violent fluctuations in the value of money under it.* The scarcity of gold helped to maintain its price at a substantially stable figure and for one century between 1815 and 1914 the changes in the value of money and their concomitant evils were not so great, intense and wide as they were in the post-war period. A stable price and income structure built on the solid rock of gold had led to the development of *an extensive and ever-growing credit structure* which supplied the financial needs of an ever-expanding industry and commerce.

Its Operation.—The essence of the gold standard, as pointed out by Prof. Gregory, is that the price of gold or the value of gold in monetary units is fixed by law, and this determines the value of the mone-

tary unit itself. The use of gold coin fairly closely approximates to this ideal. The value of the monetary unit can only vary with that of the commodity with which it is tied. In the first form of the gold standard we have gold coins in active circulation. But in all the civilised countries of the world the active circulation of gold coin, with a view to economise gold, has been supplanted by issue of currency notes and credit. Bank credit especially in the western countries, has become the principal medium of payment. The maintenance of a cash reserve for convertibility of notes is a dead loss to the bank to escape which the device of pooling the reserves or their centralisation has been evolved *i.e.* the creation of a bankers' bail or Central Bank controlling both currency and credit. The issue of currency notes is however, covered by a gold reserve with a view to meet contingencies due particularly to an adverse balance of payments or to an adverse balance against a country in the world market. A Central Bank of Issue having no rediscounting facilities would naturally keep a higher proportion of gold reserve in relation to its note issue. Banks with rediscounting facilities usually keep between 10 to 15 per cent of their balances. The Central Banks or other currency authorities controlling the gold reserve or currency in every country are the dealers in the world

market for gold and undertake to buy or sell gold in unlimited quantities at fixed prices. Their gold reserves, as it were, form their stock in trade. Through the Bank Rate of Discount the Central bank controls the loans and discounts of other banks and thus through a round about process manipulates the value of money. The value of the monetary unit or the general level of prices in a country depends upon the action of the banks in creating credit and the Central Bank controls their creation of credit by controlling the supply of cash. If the Central Bank is to adopt a policy of never refusing to lend on sound security, it must be prepared to make good any shortage in the note circulation by lending. If in doing so it exceeds the legal limits of note issue it should keep a margin of its power of note-issue in reserve or it must keep a gold reserve exceeding by a suitable margin the prescribed amount by law.

As adverted to above, the major portion of payments of business in western countries are made with bank credit and the banking system enables them through the clearing house institutions, to be cleared or set off against one another. Thus, bank credit is the pivot around which industry, commerce and trade cluster. The Central Bank in all gold standard countries is the supreme authority controlling both credit and currency. The demand for legal ten-

der money comes mainly from those who have no banking accounts like wage earners etc., because their financial transactions are too small. The Central Bank supplementing metallic money by the issue of small notes without encroaching upon its cash reserves, avoids the exhaustion of the latter and its concomitants. *These notes are freely convertible into gold coins and the monetary unit fixed in terms of gold, the gold standard is maintained.* The demand for gold as a commodity for industrial purposes is generally too insignificant as compared to its demand for monetary uses, to trouble a Central Bank. Gold is no doubt a commodity with a world market and with a world price to which the Central Bank has to conform, but there is no world monetary unit. Gold has a different price in every country reckoned in the country's own monetary unit. In fact, *the market for gold is simply the market for gold standard currencies wherever gold standard predominates.* A world price for it only exists because the different monetary units are related together by the foreign exchange market. Thus says Mr R G Hawtrey in his "The Gold Standard in Theory and Practice", *'The foundation of the gold standard is the tying of the value of the monetary unit to the value of gold by fixing of the price of gold.'* In as much as gold is a commodity with world market, it has a world value, and therefore the gold standard gives a world value to the monetary unit.

itself This world value of the monetary unit can only be made effective through the foreign exchange market '

The foreign exchange market is an organisation by which payments to be made in different monetary units can be set against one another, provided different monetary units be valued in terms of one another. In fact, the various foreign exchange markets of the world form a single international organisation. Mostly banks who control the supplies and demand of credit instruments through manipulation of prices deal in these foreign exchanges and settle the price for every foreign currency in terms of one another. In a gold standard country the value of gold being the value of the monetary unit, the price of the currency of one gold standard country in terms of that of another is the value of gold in the former in terms of the value of gold in the latter, and it can only be different from parity by a very small fraction representing the cost of transporting gold from one country to the other. In other words, the prices in any one currency of gold in different places cannot differ by more than the cost of transporting gold between the two places, and even between the most distant centres it does not much exceed 1 per cent.

Under the gold standard system, "If the value of the currency of any country in

terms of foreign currencies is raised, the effect is to make commodities at world prices cheaper to consumers in that country, and to stimulate imports, at the same time, the cost of production of exportable products is increased in comparison with the cost of the same products abroad, and exports are checked." In other words, it becomes a country in which it is more profitable to sell than to buy, hence, imports increase and exports decrease. This increase in imports increases the demand for foreign currencies while the decrease in exports decreases the supply and equilibrium is ultimately restored by exports of gold for the balance from the reserves of the Central Bank of the country which has to defend its gold, regulating the value of the monetary unit in terms of wealth through its Bank Rate.

The guard against the exhaustion of the reserve is essential to the maintenance of the gold standard Similarly, a reduction in the value of the country's currency in terms of foreign currencies would stimulate exports and check imports, because in that case, it becomes more profitable to buy from, than to sell to, that country. In either case the alteration in the price of the currency tends to bring about a state of equilibrium more or less automatically. Thus we find that *the significance of the gold standard lies in making the foreign exchange market an organisation for the clearing of international debt*

Gold Exchange Standard It is a practical device for economising the use of gold in the gold standard. Under this system the internal currency consists of silver and currency and bank notes which are convertible into gold at a fixed ratio for foreign purposes only. *Gold does not come into active circulation.* It is just like the adoption of the payment of balances between banks at the clearing house by cheques instead of with money. "In international monetary affairs gold is used as a medium of exchange not between different *commodities* directly, but between different *currencies*." In this case the right to receive gold serves the same purpose as gold itself. *The central reserve here is held in foreign currencies and not in gold.* It is argued that the holding of a gold reserve, when an interest bearing reserve of bills will serve the purpose as well, is a loss and a burden, and since the value of gold in terms of wealth depends upon the demand for it for monetary reserves to so great an extent, this method seriously threatens its stability in value. *'Gold coin is in fact an imperfect application of the gold standard. Its use leads to uncertainty and variations in its nominal gold value through the imperfection and the wear and tear of coins. The essence of the gold exchange standard is the provision of a cheap*

currency consisting of token coins or notes and the maintenance of the value of that currency as near as practicable to a fixed parity with gold. It involves governmental interference with monetary and credit conditions to an unduly great extent. The government by manipulating exchanges and strictly regulating the internal currency according to its own needs usually rather than those of business, maintains the parity with gold through the provision of adequate reserves in gold bullion or its equivalent in bills on one or some of the gold standard countries. *This reserve is normally kept in a foreign centre with whose currency unit the currency of the country is linked, e.g. India's gold reserves were kept in London, those of Japan before the War chiefly in London and Paris and those of Philippines in New York etc.* A parallel reserve in the token currency and silver called Paper Currency Reserve in our country was also kept to meet demands of foreigners for payment to nationals of the country. The government here is not legally bound to buy and sell gold at a fixed rate as in the genuine gold standard. Moreover, for the successful operation of the standard *the parity value of the silver coin is usually fixed higher than its intrinsic value* to make expansion and contraction of currency convenient when necessary. For example, the Indian rupee is a token coin whose face value is far higher than its intrinsic

value and it is not freely coined In fact *it is a note printed on silver*

Whenever the demand for foreign remittances tends to force the exchange rate away from the fixed parity the government sells foreign exchanges The remittances are paid for in notes or silver, as the case may be, this leads to contraction of internal circulation increasing the value of the monetary unit and tends to restore the exchange to parity These are paid from the gold or exchange reserves in the foreign centre thus reducing the government balances of gold or gold exchange Conversely, when the demand for remittances from foreign countries to the gold exchange standard country increases and tends to raise the exchange above the fixed parity, the government then sells remittances homeward drawn on the state treasuries or agencies and payable in silver or paper Their payment then leads to an inflation of internal circulation, to a fall in the value of the monetary unit, to normal exchange rate and to the increase of gold or exchange reserve in the foreign centre Thus, the ultimate result is the same as if gold has been exported or imported In this system *emphasis is laid more on the stability of exchange* and in theory the government is supposed to intervene only when the exchange has diverged from parity sufficiently to make the movement of gold profitable. The system was

introduced in India in 1893 where it functioned with a fair degree of success till the Great War, in Russia in 1894, and later on in Japan, Holland, Austria, Hungary and the Philippines. Before the war the system operated successfully everywhere and after the war on reorganisation, Austria Hungary, Belgium and Germany adopted the principle of the system for stabilising and maintaining their rates of exchange with gold standard countries.

An exchange standard works efficiently so long as conditions in the foreign country in whose currencies the reserves are held are normal but it is never always so. *A war or depreciation in currency moratorium or control of exchanges may upset it or the market for securities may become disorganised or blunders on the part of authorities controlling the foreign currency may interfere.* For example, the tying down of the Indian Rupee to the chariot wheel of Sterling compels the Rupee to sink and swim with it. These were the two forms of the Gold Standard prevalent before the War.

Gold Standard during War and the Post War period

War and the Ruin of the gold standard — The gold standard upto the outbreak of the Great War satisfied all the desiderata of a sound system of currency viz stability, elasticity, simplicity, automatic working, and the ready convertibility of the token

currency into standard money on demand and the investors had pinned their faith to it. They had come to look upon it as the most stable system which human intelligence could evolve. But the faith of the investing public in the stability and permanence of the gold standard received a rude shock when the Great War broke out. It gave a tremendous shock to the international monetary and financial organisation which was epitomised in the gold standard and left behind it the long legacy of financial crises, unprecedented inflation of currencies, abnormal rise in prices and a complete breakdown of the domestic and foreign exchange machineries of practically all the countries of the world.

The abnormal circumstances of the War, the necessity for large quantities of money in circulation to expedite production and distribution of commodities essential for the prosecution of the war, and the difficulty of raising sufficient revenue from taxes led to inflation of currencies in all combatant countries on an unprecedented scale. The free movement of gold which had been responsible for the maintenance of stability in the foreign exchanges was stopped. Practically every country put an embargo on its export and therefore the international market for gold and gold exchanges was disorganised. Prices rose very high. First of all, the price of gold rose, then wholesale prices,

then cost of living, then retail prices and then ultimately wages had also to be raised. Rents and interest also rose. Artificial scarcity caused by the abnormal conditions of the war in export and import trade and by the preoccupation of the governments and the people in the production of war materials, and the shortage of shipping tonnage and submarine menace, led to a very heavy rise in the general level of prices. There was a boom in all sorts of productive activities. Industrialists and businessmen made roaring profits and the standard of living was raised artificially. All the familiar phenomena of inflation were visible. The rise in gold prices and embargo on gold exports dislocated exchanges and caused a good deal of speculative activity.

After the cessation of hostilities, the war time boom was followed by a severe slump and trade depression, deflation of currency and credit, falling prices, unemployment and bankruptcies, etc. The unexpected and violent fluctuations in prices and foreign exchanges discredited the gold standard and the system began to be criticized by eminent economists, bankers and financiers, and an attempt was made to canvass the world for the overthrow of the gold standard and its replacement by a more stable and scientific system of currency. The chaotic conditions of currencies, however, necessitated their

stabilisation as the first and foremost thing in currency reforms in the post-war period

Restoration vs. Replacement.—Since 1922 international conferences under the auspices of the League of Nations mooted the question of stabilisation of the currencies and the restoration of the gold standard. Broadly speaking, there were two schools of thought, one advocating the restoration of the gold standard, and the other, its abandonment and replacement by a scientifically managed system of paper currency. The first school was represented by Prof. Gustav Cassel and others and the second notably by Mr J. M. Keynes. Mr Keynes was the most implacable opponent of the restoration of the gold standard and he denounced it in his classical phrase "*gold is a barbarous relic of the past*".* According to him, it was not necessary that the same commodity should be a medium of exchange and a measure of value. Even in the pre-war period the internal circulation in most countries consisted of notes and deposit currency or cheques and gold coins seldom came into active circulation. They were simply kept in reserve to insure against dangers of over-issue and to convert notes on demand. In this way the use of gold was confined to the reserve and there was an economy and saving in wear

* A Tract on Monetary Reform.

and tear *Gold standard was an expensive system of currency unsuitable for the nations of Europe impoverished and exhausted by war*, and people in them were so much used to the paper currency that the use of gold coins in day-to day transaction was considered a sign of backwardness. The chief quality of money being its universal acceptability, anything can serve the purpose of money which commanded universal acceptability, provided it was clothed with legal tender quality by the government. Paper money, on account of the government sanction behind it, fulfilled this condition. The dangers of over-issue could be guarded against by adequate provision of reserves and by restricting the powers of the issuing authority for the supply of emergency currency. Mr Keynes also proved by historical references how the much talked-of stability of prices and exchanges under the regime of the gold standard was in reality untrue. But the public in general had been so much used to the gold standard that they attached a sanctity to its restoration and their sentiments were in its favour.

Stabilisation

Deflation vs Devaluation —The problem of stabilisation was, therefore, solved by a restoration of the gold standard. An acute controversy raged round the issue whether the currencies were to be stabilised on

their pre war parities or at new parities of exchanges warranted by the existing structure of incomes and prices. In other words, the controversy was whether stabilisation should be brought about by deflation or devaluation. The return to the pre war parity meant deflation and the stabilisation at new parities meant devaluation. Deflation implied a contraction of the circulating media with a view to a reduction in the price and income structure to such an extent as to bring about the parities of currencies existing at the eve of the War, whereas, devaluation implied a reduction in the metallic content of the coin as fixed by law for minting purposes by an Act or Statute of Parliament to make it accord with the existing level of prices or its purchasing power in terms of commodities, thus to establish new parities and stabilise the currencies at them.

The adoption of deflation meant a tedious and long process of currency contraction with its evil effects *viz* appreciation of money, fall in the level of prices, depression in trade and production, increased unemployment, rigorous retrenchment and economies, losses to debtors and businessmen and violent fluctuations in exchanges. The psychological effects of deflation would be all the more disastrous. In spite of its drawbacks, however, some countries, England being the most important among

them, stabilised their currencies at pre-war parities by deflation, and thus restored the gold standard. Subsequent history has shown that the much desired stability of exchange was purchased by such countries at a high price and many critics have attributed the fall of the pound and the decline in the export trades of England after 1929 to the fixing of the pre-war parity of exchange.

Other countries, notably France, adopted a policy of devaluation for stabilising their currencies whereby the gold content of the currency was reduced from its previous weight fixed under the mint law. This had the advantage of saving the country from the evils and horrors of deflation. Moreover, it was easier to stabilise a currency at its new purchasing power than it was in a process of deflation. However, devaluation had also its disadvantages. The value of the currency was no longer tied to a fixed quantity of gold but had to change constantly with every change in its purchasing power. "The rubber was shifted from its value to its weight. This necessitated a corresponding change in, and regulation of, its exchange ratio. It was a fraud perpetrated on long-term creditors who stood to lose in repayment of loans by the debtors. It necessitated the maintenance of scientifically prepared and regular index numbers of prices.

At a time when an unprecedented infla-

tion of currency had led to the supplanting of metallic money by inconvertible paper currency it was very difficult to find out the parity of exchanges between two countries for the purpose of trade and stabilisation. The difficulty was further increased on account of the constant fluctuations of prices in regimes of paper currency. To solve the difficulty Prof. Gustav Cassel developed his famous *theory of purchasing power parity*. The essential elements of the theory are, the purchasing power of the currency is measured in terms of commodities, index numbers are then to be prepared showing the fluctuations in the value of the currency from the war, the year 1913-14 was to be taken as the base year wherefrom the relative changes in the values of currencies of two countries were to be compared with the base year and their ratios were to be determined according to the proportion or degree of change in their purchasing powers in their respective countries. In this way the ratio of exchange between any two currencies was to be fixed. This ratio is called the *purchasing power parity*.

Restoration of the Gold Standard

The gold standard was restored in England in 1925 and in India in 1927. But the essential features of the gold standard established then were fundamentally different from those of the pre-war gold standard. To avoid the pitfalls of both

the specie and the exchange standards and to economise the use of gold, *the Gold Bullion Standard* was established.

The bullion standard was the invention of Ricardo and was adopted in the Act of 1819 but did not come into operation. The Gold Standard Act of 1925 revived it in England by *suspending the free coinage of gold and convertibility of Currency and Bank of England notes into gold coins and by obliging the Bank to sell gold in 400 oz. 11/12 fine at at the rate of £ 3. 17. 10½ per ounce.* An interesting feature of the Act was that sovereigns had then become convertible at the Bank of England into gold bullion at a parity on the same terms as currency notes and it was therefore no longer necessary to meet them except when small quantities of gold were required. Thus, *the main purpose of the G. B. S. was the prevention of gold from getting out of the Bank's reserve into the pockets of the public to be utilised as currency.*

The international conference at Genoa in April 1922 laid emphasis on the co-operation of the central banks of issue of the principal countries in regulation of credit with a view to prevent undue fluctuations in the purchasing power of gold by undertaking to buy and sell gold at their respective fixed prices without limit. It further recommended that a convention to centralize and co-ordinate the demand

for gold and avoid competitive efforts to secure reserves should be made, and an economy of gold was to be attained by a system of reserves in the form of mutual foreign balances. An international clearing system should be established and the Central Banks should organise a future market in foreign exchanges. Any country not possessing a Central Bank should establish it. It was in pursuance of these recommendations that England adopted the G. B. S. In India also in 1927, on the recommendation of the Hilton-Young Commission, the gold bullion standard was introduced.

Thus, the pivot of the whole system here is a Central Bank controlling both currency, and credit, stabilising exchange and international prices, and serving as a custodian of a country's banking and credit interests. It is *par excellence* a bankers bank. This standard is free from the defects of the gold specie standard. There is *economy of gold* because there is no gold in circulation and there is a central reserve replaced in circulation by paper money or tokens. If the entire needs of the community for legal tender money are met by these, the gold reserve is required only for meeting an external demand. Before the War each Central Bank regulated the value of its own country's currency units to keep its gold holdings up to the prescribed limits. In this way all the currency units were kept

near gold parities. "The value of every currency in relation to every other was approximately fixed, but the value of all in terms of commodities varied, because the value of gold varied."* Each country thought the value of gold being determined by forces beyond its control, but in reality, these forces were simply the effects of the monetary demands of the different countries themselves. If the Central Banks co operate together they can control these monetary demands and "the value of gold will conform to the value of the currency units instead of the value of the currency units conforming to the value of gold." To gain this object the Central Banks must buy and sell gold at their respective fixed prices without limits. Hence, the advocacy of the gold bulion standard

Pre War vs Post-War Gold Standard

PRE WAR	POST-WAR
1 Gold is a medium of exchange and a measure of value i.e., gold is coined freely and coins of gold are standard coins and circulate	1 Gold is a measure of value but not a medium of exchange Gold is not coined and coins of gold do not circulate
2 Notes are convertible on demand into gold coins	2 Notes are convertible into gold bullion and not coins and that too in quantities of not less than 400 oz bars.

3	Gold is obtainable freely in any quantity for internal or external uses	3.	Gold is obtainable freely only in bars of 400 oz either for internal or external purposes
4	It is an automatic system of currency	4	It is a 'managed system of currency controlled by the Central Bank
5	It lays more emphasis on stability of exchanges rather than stability of internal prices	5	It lays more emphasis on stability of prices rather than stability of exchanges

Thus, we find that the gold bullion standard is different from the gold specie standard in various ways, but in its fundamentals it is as good as the specie standard. Nay, it has all the advantages of the old standard and at the same time economises the use of gold by withdrawing it from circulation and thus saving it from wear and tear. There is a saving in the cost of minting because the currency consists mostly of paper tokens. The gold in reserve is more serviceable in strengthening of exchange than gold in circulation. Moreover the quantity of gold in reserve is much less than the required quantity for circulation and thus a release of gold from circulation enables a larger number of countries to adopt the gold standard. The economy and saving in gold thus achieved increase the investments of a country adopting gold bullion standard and add to its

sources of income. Its stability is, however, based on the confidence of the public in the soundness of the financial position of the authority issuing currency.

Breakdown of the Gold Bullion Standard

The stability of exchanges, and of trade, production and employment, consequent upon the restoration of the gold standard in its new phase was very short lived. During 1925-29 the curve of prosperity was ascending and the world was settling down to normality after a prolonged period of disturbance as a result of the War and its aftermath. But this was given a sudden and violent shock in 1939, and the world had to pass through another unprecedented economic blizzard sweeping across the world and enveloping every country in it. The Wall Street crash of 1929 and the collapse of the world prices followed by the failure of the Credit Anstalt in 1931 heralded the depression and the gold bullion standard was knocked down in England in 1931 and some countries followed her soon and others later on.

So far as England was concerned, the restoration of the gold standard and its stabilisation at the pre-war parity with the Dollar had led to its overvaluation by 10% between 1925-31. This made the English economic system unstable and precarious. Export industries and trades were at a

disadvantage, and the overvaluation of the sterling had intensified foreign competition in the home market. Profits in certain trades were reduced which in turn diminished the Government revenues. The Government therefore had to follow an impossible task of keeping money easy to help revival of trade and trying to reduce the overvaluation of the pound by tightening money. Under such circumstances only a few industries were prospering and a majority of them were experiencing depression. In 1927 the Bank Rate was reduced to $4\frac{1}{2}\%$ in London and it remained there for two years. In spite of an unemployed figure of 1 000 000 business was not bad stock exchange was active and prices of securities steady. But commodity prices showed a slight fall. America was also following an easy money policy to help the restoration of the gold standard in other countries which were demanding gold to strengthen their reserves. This deliberate policy of cheap money (N Y Reserve Bank's rate was $3\frac{1}{2}\%$) led to speculation. Economic conditions in home country required a policy of dear money and a check to speculation, but conditions outside demanded a policy of easy money to avoid a further accumulation of the already excessive gold stocks in the country. After stabilising the *franc* France was also becoming a competitor for the world's gold and began to accumulate it in the vaults of its Central Bank.

The N. Y. Reserve Bank authorities under these circumstances delayed in raising the bank rate. England was following a similar policy of cheap money at home to encourage trade and reduce unemployment, and tight money policy to check stock exchange boom in the London money market. In spite of the ultimate raising of the N. Y. rate to 5%, the call rate shot up to 10, 15, 20% without appreciably checking the demand for loans. Such high short money rates led to the investments of funds from outside in large amounts, and this flow of short funds was rapidly followed by an appreciation of the dollar exchange and an import of gold. London in the first week of February 1929 lost £3m. The Bank Rate in London was then raised to 5½% to stop the efflux of gold and stock exchange boom. Call rate in New York still remained high and the Bank Rate was only tardily raised to 6% when it was too late. Then followed in England the failures and criminal prosecutions of many speculators on the stock exchange and on September 26th the Bank of England was compelled to raise the Bank Rate to 6½% to check the loss of its gold to America, France and Germany and to remove the difficulty of getting treasury bills taken up. This stopped the flow of funds to America, but it also led to the crash by giving a mortal blow to the stock exchange boom there. Stock prices began to fall there heavily in November, and, by

the end of 1929 the level of stock market prices were brought down to 50% causing a large number of bankruptcies among the speculators

This collapse of the Wall Street precipitated the general depression in trade. By February 1931 the wholesale prices in England fell by 26% and unemployment increased from about $1\frac{1}{4}$ m to $2\frac{3}{4}$ m approximately. Conditions were worse in Germany and U S A. Then the primary products all round the world were most badly affected. This economic depression was due to many causes. "Loss of confidence, wide and growing disequilibrium between prices and costs, abortive attempts by tariffs, restrictions and pools to stem the fall in prices, the burden of war debts both internal and external increasing daily with each fall in prices, the bankruptcy of stable trades and even of nations due to the collapse in the prices of their main products"—these and others have been cited as the causes of the depression. But it is difficult to say how far these were the causes or the results of the depression, and their discussion need not be attempted here.

There has been a great controversy round the question whether the depression was the outcome of the restoration of the gold standard or it was the operation and management of the gold standard which

was responsible for the depression. As a matter of fact the depression was due to two sets of causes—monetary and non-monetary, and, among the monetary causes, the operation of the gold standard in the post-war period occupies a very important place.

It was but natural that the restoration of the gold standard in general would lead to a downward trend of world prices. High prices before stabilisation were the outcome of inflation and, as stabilisation at pre-war parity meant deflation, the price-level must come down to some extent. The fresh stocks of gold since then, and the economies effected in gold through the adoption of gold bullion and gold exchange standards in some countries, released a larger stock of gold to be kept in the reserves of the central banks so that the prices in the post-stabilisation period would have been higher than the pre-war level. However, all kinds of prices did not readjust themselves in this way. Commodity prices no doubt got adjusted but rents, interest on long term internal and external loans of all kinds, wages and salaries etc. did not so easily and readily adjust themselves to the changed conditions. Retail prices practically remained the same and so did the cost of living. It was thus the primary products and raw materials which had to bear the whole brunt of the readjustment and there was an ever widening gap between

their prices and costs. It was this very rigidity of costs and wages which created difficulties for the English export trades and intensified the overvaluation of the pound.

Then the *gold resources of the world were unevenly distributed over various countries*. The War had left U S A as the *creditor country of the world*, where, on account of the heavy purchases made by the belligerents, a huge quantity of gold had got accumulated. Then her tariff policy, which shut out foreign goods, prevented the debtors from paying back the interest and sinking fund instalments by exporting goods to her territory. This intensified the accumulation of gold in the post-war period. Then her *debt policy of not lending to foreign countries*, but investing the surplus funds in the economic development of the country itself, and sterilising the gold, prevented her from playing the "gold standard game" i. e., lending freely to foreign countries and preventing an excessive accumulation of gold within its territory, to the detriment of other countries. This was what England, the pre-war creditor country, had been doing before the war together with France etc., and that is why the gold standard had been successfully maintained. Then finally, the *Wall Street boom had also led to accumulation of gold there*. In the post-war period France also became a competitor for gold with America, and, on account of her

tariff policy and the growth of *aggressive economic nationalism*, she also accumulated a huge quantity of gold which she received in payment of the *war debts and reparations*. France was prepared to invest abroad and encouraged her investors to do so but the unsettling conditions of 1930-31 deterred them from doing so. Thus, *about 2/3rd of the world's gold had accumulated in America and France* each one of which had followed a policy of *sterilising gold, protectionist tariff, and encouragement of exports which must accumulate gold*. As Clive and Crump remark concerning U S A "A country that will not buy foreign goods, that continues to collect her debts and which will not or can not invest money abroad, must if she wishes to maintain her export trade, end by accumulating gold."⁴

As the depression advanced, there was loss of confidence. A spirit of pessimism had caught the people and this slowed down the velocity of circulation of money and credit. They were not prepared to spend or invest. This caused an accelerated fall in prices and a phenomenal fall in interest rates. In 1931 the Bank rate in London was 3%, in New York it was 2% and in France also 2%. How paradoxical it was that while the depression was attributed to a shortage of gold, there was such a plethora of loanable funds as to

⁴A B C of Foreign Exchanges

bring down the rate for short term bills and loans to 2 and $1\frac{1}{2}\%$ in important centres. This was due to the loss of public confidence.

Owing to the over-valuation of the pound the investments of England overseas were greater than her excess of exports over imports. This she did by exporting gold and by raising short term loans. She was "borrowing short and lending long." According to the MacMillan Committee she had borrowed between 200 to 300 million pounds in 1931. Thus, the position in England in 1931 was as follows: 'The pound was over-valued, British wages, production costs and the cost of living had remained rigid at a time when world prices were tumbling down, gold was flowing out of the country, and stability of the exchanges and the gold standard itself were only maintained by the presence of foreign short-term funds in London.' This proved to be the vulnerability of her financial strength. At a time when the loss of confidence was in the air and the world was heading towards a crisis and an inevitable disaster, *the presence of foreign short-term balances proved the greatest difficulty and this proved as the most potent cause of the break down of the gold standard there.* There were only two courses open: one to reduce wages, costs and internal prices and the other to go off the gold standard. On account of the strength and temper of the

trade union movement the first was not possible and therefore she adopted the second course.

The fall of Credit Anstalt in Austria led to the suspicion about the stability of Germany which caused a run upon Germany's foreign assets and gold balances so that by the middle of June the Reichsbank had to choose between drastic credit restriction and the abandonment of its 40% reserve ratio. Then came the Hoover moratorium for one year suspending the payment of war debts and reparations and the receipt of credit of 100 m dollars from other central banks by the Reichsbank, but by the middle of July in spite of this help the German Bank had to suspend payments. Then the distrust of the world in the stability of England increased further on account of her budgetary deficits and commitments in Germany. *The over valuation of the pound and the consequent dislocation of the favourable trade balances had also led to the reduction of government revenues which was intensified in the depression, but the expenditure could not be brought down.* The unemployment insurance scheme of the Government when the depression was increasing every day the number of the unemployed and increasing the cost of maintaining the unemployed, had led to serious difficulties. By 1931 the Insurance Fund had run heavily into debt and as a result of this while the budget

was balanced government expenditure exceeded government revenues. The investigations of the May Committee confirmed the weakness of the national finances of England. Unfortunately the report of the Committee was published in the middle of the German crisis and this led to the belief of the foreign peoples that the British Government was bankrupt and the City of London had lost millions of pounds in Germany. Hence there followed a sudden withdrawal of huge funds from London chiefly to France and to other countries also. This caused the exchanges to depress and heavy gold shipments to all centres except New York which declined to draw gold as a friendly co-operation. By 29th July in three weeks the gold reserves of the Bank of England fell from 164m. to £132m and the Bank rate was gradually raised from $2\frac{1}{2}\%$ to $4\frac{1}{2}\%$, the reserve in the Banking Department fell to £33 9½m. and the "Proportion" to $32\frac{3}{4}\%$. To meet the situation the fiduciary note limit was raised from 260m pounds to 475m. pounds and remained in force till 1933 and New York Reserve Bank and Bank of France granted a credit of £25m. each in their respective currencies. However, the drain from London could not be checked and within a fortnight the Banks' credits were on the brink of exhaustion. Both France and America refused to lend more until the budget was balanced and finances improved.

by retrenchment and economies on the one hand and higher taxation on the other. On its refusal to do either of these things the Labour Government had to go out and a National Government came to power with an assurance to balance the budget. Then by the end of August both France and America between them lent a credit of 80m pounds but in spite of this the withdrawal of funds from London could not be checked. *The overvaluation of the sterling which still persisted, the belief that British had large funds choked up in Germany on account of the German standstill agreement, and the unrest in the British navy caused by reduction in pay intensified the loss of confidence.* Thus, by September 20, 1931, when more foreign credit could not be raised, and the gold reserve had reached the limit of safety and since the middle of July more than 200m pounds had been withdrawn from London, the Government suspended the operative clause of the Act of 1925 which required the Bank to sell gold at a fixed price, so that the gold reserves might not be further depleted. Purchases of foreign exchanges or transfers of funds except for legitimate trade purposes, for reasonable travelling or other personal purposes and for contracts existing before 21st September, were prohibited. The Bank rate was raised from $4\frac{1}{2}\%$ to 6%, and the Stock Exchange was closed for two days. Thus England went off the gold standard and as a consequence, the pound sterling

became undervalued, and gradually the British prices began to improve and her foreign trade and industries got a breathing time. Similarly, India went off the gold standard on September 21, 1931 and Banks opened after a holiday for three days. Now both of these countries have the Sterling Exchange Standard in which the pound sterling is the standard of value.

Gradually, the gold standard was suspended in other countries also and by 1933 it had ceased to function in practically all the important countries. There is no possibility of its revival in the near future.

To summarise —The main causes of the breakdown of the gold standard generally were (a) War debts and reparations⁵. The increase in international indebtedness was a legacy of the war and necessitated the transference of wealth from one country to another on a very large scale and caused disturbing gold movements (b) Mal distribution of the gold supplies of the world. Between 1929-31 world's total monetary gold stock increased by 8% while the holdings of France and U S A increased by 19½% and 74% respectively and the stock of the world decreased by 32% (c) Tariffs, quotas, import boards, rings, pools, cartels, and trusts and other sorts of restrictions on output and the consequent meddling with

⁵ Cassels's 'Crisis in the World Monetary System'

the price mechanism and its regulator, the free competition. (d) Growth of a policy of aggressive economic nationalism and autarchy followed by some countries. (e) The failure of America and France to play the gold standard game (f) Lack of international co-operation among the Central Banks, and (g) Political disturbances consequent upon the Treaty of Versailles

of currency systems prevailing in the world) The dealings that are carried on between different countries by way of exports and imports of merchandise etc., give rise to the foreign exchanges. The different countries of the world have different systems of currency, and the nationals of every country want to be paid in terms of their own currency and not in foreign currencies, but the foreigners can pay in their own currencies. (Therefore, there is the necessity of a mechanism with a number of institutions for exchanging the currency of one country in terms of the currency of the other to effect the payment from the nationals of one country to those of the other. That is why Hartley Withers has defined foreign exchange as "the art and science of international money-changing."²

The exports and imports of a country, to use a book-keeping terminology, are like debits and credits which are set off against one another through the mechanism of the foreign bills and the excess one way or the other alone is liquidated in specie or gold.) Payments to foreign countries are usually made either by sending goods abroad in exchange, or by export of specie or gold, or by bills and drafts. Of these three well-known methods of making payments to foreigners, the last one is the

² Money Changing.

(cheapest, most convenient and the most popular. The transport of specie is very expensive, inconvenient and risky.) The sellers of various countries usually draw upon the foreign buyers 60 or 90 days after sight bills and attach a number of documents to them *viz.*, an invoice, a copy of the bill of lading (embodying the contract of affreightment and serving like a railway receipt in inland trade, as a document of title, the production of which entitles the importers or their agents to take delivery of the goods from the captain of the ship), a copy of marine insurance policy and a letter of hypothecation (pledging the goods as a security for advance from the bank and authorising it to dispose of the goods in the foreign market if the importers fail to take delivery or accept or pay the bill as the case may be, and undertaking to indemnify the bank if it sustains a loss thereby) These bills are usually drawn up in sets of three and are either on D A or D P. terms The former means documents against acceptance and the latter documents against payment. In the first case, the documents of title are to be surrendered to the importer only when he has accepted the bill, and in the latter case, only when he has paid the bill The exporters, however, cannot afford to wait for such a long time for the payment of the goods and lose interest on their capital invested in the goods Therefore, they

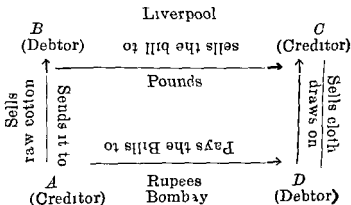
discount these documentary bills with banks or discount houses carrying on the business of bill broking and discounting. There are regular markets in important commercial centres for the buying and selling of such bills. Bills of exchange and other commercial credits form the stock-in-trade of these markets and the dealers in them are banks etc. Like ordinary commodities the prices of these bills are determined by their conditions of demand in relation to supply. If the supply of the bills on a certain monetary centre increases, other things being equal, their prices would go down, and a decrease in supply will cause a rise in prices. If the demand increases, other things being equal, then their prices will go up, and if the demand decreases the prices will go down. The price at which such bills in a country on a particular foreign centre are bought and sold at a certain time is called *rate of exchange*. The buyers or importers of the country who have got to make payments to foreign creditors purchase these bills from the Bill Markets through their banks and send them in discharge of their debts to the foreigners. Through the mechanism of the bills therefore exports serve to pay for imports.

The theory of the exchanges or the Settlement of Debts through bills—To illustrate the operation of a bill of exchange in the settlement of debts let us assume that

India and England trade together and that each of them buys goods of the same amount from the other. Suppose *A* in Bombay sells raw cotton worth Rs. 1,000 to *B* in Liverpool, and that *C* in Liverpool has sold cotton piece goods worth Rs. 1000 to *D* in Bombay. That is to say, *A* is the Indian creditor and *D* is the Indian debtor, *C* is the English creditor and *B* is the English debtor, and that the amount owed both ways is equal. *A* the Indian creditor, will not accept pounds sterling from *B* in payment for his goods, nor *C*, the English creditor, will accept the tender of Rupees from the Indian debtor *D*. Therefore, the importer *B* in Liverpool and the importer *D* in Bombay must remit gold worth Rs 1000 either way across the seas so that the specie or gold will have to travel half way across the world and back again. This will entail heavy expenses on transport and insurance. But all this expense and inconvenience can be avoided by making payment through a bill. The theory of exchanges says that as each of the English and Indian debtors has to pay Rs 1,000 and each of the creditors in the two countries has to receive an equivalent amount, the trouble and cost of this unnecessary export and import of gold could be avoided easily by arranging that the English debtor pays to the English creditor and that the Indian debtor pays to the Indian creditor without a single

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coin or gold passing between the two countries. This can be easily done in the following way. Let *C*, the English creditor, draw a bill 60 or 90 days after sight on *D*, the Indian debtor, for an equivalent of Rs 1,000. The bill will be sold by him, *B*, the English debtor, who has to pay to the Indian creditor, *A*, will purchase the bill from *C* and pay him in pound sterling and will send it to *A*, who, on presentation, will get the amount from *D*, the Indian debtor, in his own currency. Thus a single bill will settle the two transactions and no gold will pass either way. The same result would be achieved if, instead of the English, the Indian creditor drew the bill on the English debtor.



In the above example we have taken the simplest possible case to illustrate the operation of a bill of exchange in the settlement

of international debts and in effecting a wonderful economy in the use of metallic money for the same purpose. In actual practice, it is not so simple, but there is no difference in the fundamentals of the theory of exchanges. There are hundreds of thousands of exporters and importers in India and similar is the case in England. Millions' worth of bills are drawn every year by English men on Indians and by Indians on Englishmen. (The amounts of debts do not exactly coincide in any two transactions as we have supposed in the above illustration.) The debtors in the bill market there seek bills of the desired amount through banks, and bill-brokers and, if they are not able to get such bills, then they approach the banks and get bank-drafts of the required amount made to order. It is very seldom that payment is to be made in specie when the bills of the desired amounts are not available. As pointed out above, it is only after the offset of debits against credits in the total indebtedness between two countries in trade relations that any balance is payable in specie or gold. Thus, through the instrumentality of bills, not only the expense and inconvenience of remitting large amounts of unnecessary specie in international payments are avoided, but a great economy is effected in the use of the precious metals.

Moreover, it is very seldom, in these days of interdependence of nations in the

economic field, that any two countries are in trade relations with each other only. They are at the same time in trade relations with other countries and the method of payment in that case is also through bills and mutual balancing of debits and credits. (Thus the debits and credits of one country are set off not only against one but all other countries and a still greater economy in the use of the precious metals is effected.) For example, India carries on trade with Eng and, Germany, America, France, Japan, Italy etc., then the total credits of India are set off against her total debits to all these countries through bills, drafts and other instruments of credit, and, if the total credits are greater than the total debits, the excess is payable in gold to India, and, if the debits are in excess of the credits, then India has to pay gold.) Under such international trade the excess credits of one country against another are utilised to pay the excess debits of other country or countries to her. India normally exports more than she imports but her imports from some country may be more than her exports to it, while her exports to some other country may be greater than the imports from it. She can then utilise her claims against the latter country to pay off her debts to the former by transferring them to that country. This is very often the case, and India, like so many other countries makes payments in this

round-about fashion through the London money market and foreigners pay to Indian exporters through London. This is due to the fact that London has become the "settling place of Europe and the world" on account of the ever-expanding and enormous extent of British commerce, the credit facilities of the London bankers and discount houses and their reputation, and the easy convertibility of bills on London. In spite of the growth of New York and Amsterdam as serious rivals of London, it is still the international monetary and financial centre. "A draft on London," in the words of H. Withers, "is the real currency of international commerce and finance."³ These round-about methods of payment have effected still greater economy of metallic money. In the words of Prof. Marshall, "If England has large payments to make to America, which has large payments to make to China, which has large payments to make to England England is likely to discharge part of her obligations to America by bills on China: These round-about operations are among the chief economies effected by exchanges"⁴ The settlement of international exchanges in India is done by exchange banks and their branches a description of which will be found in the chapter on Exchange Banks.*

³ Meaning of Money

⁴ Money, Credit and Commerce.

*See Money, Exchange and Banking Vol II.

Rate of Exchange

So far our discussion has shown that bills of exchange are the chief instruments for the settlement of international debts arising out of international dealings of all sorts between different countries. These bills are the object of regular sale and purchase in money and bill markets, and the rates at which they are bought and sold depend at any time upon the demand for and supply of these bills on different centres. How are these rates determined? What are the limits to their rise and fall? What are the causes of their fluctuations?

Rate of Exchange means the rate at which the currency of one country is changed into the currency of another through the purchase and sale of foreign bills of exchange. Hence, it may be defined as the price of foreign bills of exchange in one country expressed in the money of the other. It usually refers to the current rates of exchange i.e., the rates at which bills on a certain foreign centre are purchased and sold in a country. It is constantly fluctuating according to the demand for, and supply of, bills on that centre and *it is quoted either in home currency or in foreign currency.* That is to say, it may be expressed in the units of the home currency or in the units of the foreign currency, e.g., Rs. 15 = £1, or 1s. 4d. = Re. 1.

Determination of the rate of exchange : The determination of the rate of exchange between two countries in trade relations and its rise and fall depends upon various factors. (Ordinarily, rate of exchange is determined by reference to the monetary standards of the two countries and to the par or state of equality of one currency in terms of the other.) For example, if £1000 in Australia would buy a draft for exactly £1000 on England and *vice versa* the exchange would be at par. If the bill commands a higher or lower price than £1000, it will be above par and at a premium, or below par and at a discount. (With reference to the monetary standards of two countries, adopting the same metal as standard of value, this par is called the *mint par*.) And when the currencies of two countries are on the same metallic basis, the mint par of exchange between them is taken as the base, and the fluctuations in the rates of exchange are confined to two points, one the upper, and the second the lower. These points are known as the *specie or gold points* and indicate the point of gold export from, and gold import into, the country. The comparison between the pure metallic contents of the two currencies and the cost of shipment and insurance of gold between the two countries are the basis of the calculations of these points. The rate of exchange is affected by the direct expense of transportation, by cur-

rent rates of interest in different countries, by mint charges and delays, and the probabilities of shifting currents of trade. Competition among the dealers leads to a market rate somewhere between the two specie points.⁵

Mint par of exchange between two gold standard or two silver standard countries means the exact pure metallic equivalent of one currency in terms of the other. Strictly speaking there is no mint par of exchange between a gold currency and a silver currency. Mint par "is the fixed intrinsic value of the currency unit of one country expressed in terms of the currency of another, which uses the same metal as a standard of value... .. Mint par tells us how much of the other country's currency contains, according to their law, precisely the identical quantity of the same pure metal. *It, therefore, means value for value in fine gold between gold using countries, and value for value in fine silver between silver-using countries.. ... Mint par depends, in short, not on the coin itself, but on the legal definition of it, not on the sovereign de facto, but on the sovereign de jure, and if every gold coin in this country (England) were debased, and every gold coin in France sweated and mutilated, the mint par would still remain the same. Unless and until the law is*

⁵ *Taussig : op. cit* p 453.

altered the Mint par cannot alter"⁶ In other words, mint par is a legal ratio of pure metal contained in standard coins and cannot be altered without a change in the mint law. The rate of exchange is seldom at mint par, it is always fluctuating according to the changes in demand and supply of bills

The rate of exchange will be said to be at mint par when the money of one country can be changed for an equivalent amount of its fine metallic content into the money of another. The ascertainment of the mint par between two gold currencies, differing in their weights and fineness, may be illustrated by reference to the parities of exchange between the English *sovereign*, on the one hand, and the American *dollar*, or French *franc*, or the German *reichsmark*, on the other

Now, according to the English mint law one ounce of standard gold was coined into $3\frac{1}{2}\%$ sovereigns or £3 17s. 10½d. Expressed in metric weights one sovereign contains 7.98805 grammes or 123.274 grains of standard gold. It is 11/12 fine *i.e.*, out of twelve parts 11 parts are gold and 1 part is alloy, or the standard or guinea gold is 22 carats fine as distinguished from pure gold which is 24 carats fine. Therefore, one sovereign contains $(123.247 \times \frac{11}{12})$ grains or 113.0016 grains of fine gold.

⁶ *Clare and Crump A B C of Foreign Exchanges.*

On the other hand, according to the American mint law, a 10 dollar piece is coined into 258 grains of standard gold and it is $9/10$ fine; therefore it (10 dollar piece)

contains $\frac{258 \times 9}{10}$ or 232.2 grains of fine gold.

Hence, one dollar contains 23.22 ($23.22 \div 10$) grains of fine gold. By comparing the respective weight of the two coins *i.e.*, the dollar and the sovereign in fine gold we get the mint par as £ 1 = 4.8665 dollars

or $\frac{(113.0016)}{23.22}$.

This is the Dollar-Sterling mint par.

According to German mint law 500 grammes of fine gold were to be coined into $69\frac{1}{2}$ twenty marks $\frac{9}{10}$ fine which gives the mint par between the sovereign and the reichsmark of 20.42945 or 20.43 marks in the following way: £1 = $7.988 \times \frac{11}{12}$ fine grammes and 500 grammes of fine gold are equal to 1395 ($69\frac{1}{2} \times 20$) reichsmark. There-

fore £ 1 is equal to $\frac{7.988 \times 11 \times 1395}{12 \times 500}$ or to

20.43 marks, or 20.43 marks = £ 1.

According to the French mint law, before the Great War, 155 twenty franc pieces $9/10$ fine were coined from 1,000 grammes of standard gold, *i.e.*, $1000 \times 9/10$ or 900 grammes fine were coined into

155 × 20 or 3100 francs Therefore, £1 was equal to $\frac{7\,988 \times 11 \times 3100}{12 \times 900}$ or 25 2215 francs

Since 1928 it was changed and the franc was to have 65·5 milligrammes of coined gold at 900 fine and at this rate the mint par between Paris and London was changed to £1 = 124·21 francs

$$\left\{ \frac{7\,988 \times 11 \times 10 \times 1000}{12 \times 9 \times 05\,5} = 124\,21 \right\}^*$$

(Now, according to the theory of exchanges, if the total money value of exports, say from America to England equals the total money value of imports into it from England, then other things being equal, the supply of bills on London will balance the demand for bills and the exchange will be at the mint par. In actual practice, as has been pointed out above, the current rate of exchange is seldom equal to the mint par. It is rising or falling according to the demand for, and supply of, bills. If the rate of exchange is at mint par a bill for £1000 on London will sell for 4866 dollars exactly in America. If it sells for more than this amount then sterling exchange on London will be at a premium, if it sells for less than this amount it will be at a discount. The rate of exchange will be constantly rising and falling according

to the course of trade and the demand and supply of bills resulting therefrom.

Then, what are the limits to which the rate of exchange between two countries will ordinarily rise and fall? *The mint par denotes*, what may be called *spot exchange rate between two currencies*. If a debtor in America, for example, wants to clear a debt of £1,000 he can do so by paying 4866 dollars at the spot, but, if he were to send the amount from New York to London, obviously, to clear a debt of £1,000, he must send more than 4866 dollars to cover the cost of transmitting bullion, commission and insurance to London. Now, if the cost of transmitting bullion from New York to London inclusive of commission and insurance is .024 cents per sovereign *i.e.*, to clear a debt of £1 he will have to pay 4 89 ($4\ 866 \times .024$), then he must send 4890 dollars to clear a debt of £1,000. Even if gold is available, however, the debtor will like to pay through a bill of exchange on London because it is cheaper to do so. Let us suppose he goes to a New York banker having credit to sell in London and demands a draft for paying his debt. What rate will the banker quote for the bill to sell it to him? The banker knows very well that, if the debtor is not able to get a bill for liquidating his debt to the London merchant, he will have to send specie and incur .024 cents per sovereign more than the mint par, therefore, his quotation for the bill

will not go beyond 4.89 dollars per pound, because, then it will be more profitable to the debtor to purchase specie and send it than to buy a bill and send it. The rate of exchange quoted by the banker, therefore, can in no case go beyond 4.89 dollars per pound in ordinary circumstances (This highest point to which the current rate for the bills can rise is called the *upper gold or specie point*, i.e., the mint par of exchange plus the charges for freight, commission and insurance incurred in transmitting bullion. From the point of view of the American debtor it is the *gold outward or gold export point*.* As a matter of fact the rate of exchange will not in the ordinary circumstances rise to 4.89 dollars. Whenever it touches that point, it is a matter of indifference to pay through specie or a bill, although the latter is more convenient. If it goes beyond it it becomes more profitable to send specie than to purchase a bill. The rate will actually lie somewhere between 4.865 and 4.890 according to the demand and supply of the bills. If the demand is greater than the supply the rate will rise at the most upto the upper gold or specie point.

Contrariwise, if the demand for the bills

*"If there is a general excess of imports over exports, foreign exchange is at a premium and specie tends to flow out, while a general excess of exports brings exchange to a discount, and causes an inflow of specie" *Tausig op cit p 457*

is less than the supply, the rate of exchange will fall, but it will not fall below the lower gold or specie point which is obtained by subtracting the freight, commission and insurance charges from the mint par. This is due to the fact that the creditors of the country will find it cheaper to send for specie from their foreign debtors rather than sell their bills at a rate which is below the mint par by more than the cost of importing specie. It can be illustrated by the same example of the New York Banker's draft on London. If there is less demand for bills on London from the debtors in America to pay to English merchants than the supply of bills, then the banker will have to get his draft converted into specie and shipped to New York. In this case he shall get not full 4866 dollars in his currency but 024 cents per sovereign of his claim & less. That is to say, he shall get only 4842 dollars for every sovereign. But still he would like to get the amount through the bill by selling it because it is more convenient. Therefore he will persuade some debtor to accept a bill from him and shall quote a price for it which will be less than the mint par, but in no case less than the lower specie point *i. e.*, 482 dollars because in that case he would prefer the inconvenience and risk of sending for the specie to selling his bill at a price lower than the lower gold point. Thus, the rate of exchange will not ordinarily fall below the *lower gold*

point i.e., the mint par less the freight, insurance and commission charges incurred in transmitting specie. From the point of view of the creditors in America this will be gold import or inward point because, if the rate of exchange falls below it, specie will flow into America.

Ordinarily, therefore, the rise and fall in the rate of exchange between any two countries on the same metallic standard is confined within the upper and lower gold points, which are limits in the rate of exchange at which gold will flow out or flow in. If there are restrictions placed on the movements of gold and depreciated paper currencies, there are no limits to which the rates of exchange will rise and fall.

Thus, we find that the rate of exchange between two gold or silver using countries is determined by the mint par of their currencies or standard coins, and the rate fluctuates or rises and falls between the upper and the lower specie points, fixed by reference to the mint par and the cost of transmitting bullion to and fro, and depends on demand for, and supply of, bills of exchange on a foreign centre.

Determination of Rupee Sterling Exchange. Similarly, the rate of exchange between two countries, one of which is on a gold standard and the other on a silver or gold exchange standard, can be determined by

reference to the pure metallic contents of their currencies and one extraneous factor - the price of silver in terms of gold. This can be illustrated by the history of the Rupee-sterling exchange. The Rupee contains 180 grains of standard silver $11/12$ fine so that it contains 165 grains of silver. Now 480 grains make up one ounce, so expressed in ounces the Rupee contains $165/480$ or $11/32$ ounce of fine silver and $165/444$ ounce of standard silver which is equal to $55/148$ ounce. So long as the price of standard silver in the London money market did not go beyond 43d per ounce, the value of the silver bullion in the Rupee in English currency was 16d. or 1s 4d ($55/148 \times 43d = 16d$). This was the case from 1898 to 1917. Or, it can be more simply, although roughly and approximately, calculated as follows. One Rupee contains 180 grains and one ounce weighs 480 grains, therefore the rupee may be roughly calculated to contain $3/8$ standard ounce of silver, and then, when the price is 43d per standard ounce, the bullion in the Rupee will fetch in English currency $3/8 \times 43d$ or 16d approximately. In 1919 when the price of silver in the London money Market was roughly 64d per standard ounce then the Rupee-sterling exchange was fixed by the Babington Smith Committee at 2s ($3/8 \times 64d = 24d$ or 2s). Similarly, the price was taken to be 48d per standard ounce in 1925 and then the rate

of exchange was fixed at 18d. or 1s 6d. ($3/8 \times 48d = 18$) These may be taken as the mint pars between the Sovereign and the Rupee when they exchanged in ratio of Rs. 15 £1, Rs 10 £1, and Rs 13.54 to £1 respectively. The rate of exchange used to fluctuate before 1917 between 1s 4½d. and a 1s. 3¾d and these were taken as the upper and the lower specie points. *These rates were based on the artificially fixed price of silver at 43d per standard ounce, the actual price was much lower and fluctuating* Under this case, the rate was not allowed to be determined by natural forces of supply and demand of bills and the free movement of specie because the Government was under no obligation to buy and sell gold or to convert the notes into gold. It had only an undertaking to supply gold or sterling exchange at its option at the arbitrarily fixed and regulated so-called specie points and controlled the movements of the exchange between these points by selling Council Bills and Reverse Bills according to needs. If an excess of exports over imports threatened to raise the value of the Rupee above the upper point, Council Bills were sold by the Secretary of State at rates varying between the par of exchange and the upper point, and were paid out of the Indian treasuries in rupees and notes. This caused an expansion of currency and raised the Indian prices as compared to the English. On the other hand, if

the exchange tended to fall below the lower specie point, the Government of India began to sell Reverse bills *i.e.*, sterling bills on England at rates ranging between the par and the lower point. This caused a contraction of currency and falling prices, and prevented the exchange from falling below the lower point. This system of determining the fluctuations in the rate of Rupee-sterling exchange continued successfully till it broke down completely under the stress of abnormal circumstances during the Great War. Since 1924-25 this system has been abolished and now the Government regulates the exchange by the system of *purchase of sterling*. It is a more effective and efficient system of regulating and stabilising the exchange.

When one of the two countries is on a metallic basis and the other on a paper standard then the determination of the rate of exchange becomes complicated and the fluctuations in the rate of exchange are not limited within any fixed points. The paper standard country depends entirely on the supply and demand of foreign bills for making payments, and in the absence of any alternative means like export of gold, the rate of exchange, in face of keen demand, will be much above the upper specie point.

When two trading countries have inconvertible paper monetary standard, the determination of the parity of exchange

between them becomes still more complicated and difficult.* According to the old theory it will depend entirely on their respective balance of payments to each other and the demand and supply of bills of exchange based on such balance. The chief difficulty in this case arises from the fact that the value of these currencies is no longer tied to the value of a common commodity of universal demand like gold by reference to which the relative parity of exchange between them can be found out. However, there is a new theory concerning this —The par of exchange is determined by the relative purchasing power of the two currencies *i.e.*, their relative values in terms of commodities and services as shown by the relative price levels. This is called the Purchasing Power Parity. The fundamental principles underlying the mint par are still applicable although the par in this case is not legally fixed but is constantly changing according to the relative price levels, but of this more later.

Fluctuations in the rates of exchanges and their causes

Now to come to our third query. What are the causes of fluctuations in the rates of exchange?

*When specie is displaced by paper and higher prices and a premium on gold have appeared, the ordinary variations in the balance of payments and the depreciation of the paper are two sets of influences on the foreign exchanges. *Taussig*, op cit p 463

The foregoing discussion has shown very clearly that the rate of exchange depends on the demand and supply of foreign bills of exchange which are created through the movement of goods, services, securities and capital etc. (Formerly it was thought that the bills were created only by the movement of goods and therefore the rate of exchange was said to be determined by the balance of trade.) If the exports of a country are in excess of its imports, it has to receive more from others than to pay to them and therefore its balance of trade is said to be in its favour. There is a greater demand for its currency in foreign countries than its own demand for the foreign currencies and therefore, it shall be at a premium *i.e.*, its currency will have a greater purchasing power over the currencies of the other countries, and therefore, the rate of exchange will be favourable to it. On the other hand, if its imports are in excess of the exports, it has to pay more than to receive from other countries, and therefore its balance of trade will be against it. Its currency will be less in demand by foreigners than its own demand for foreign currencies, and therefore, it will have less purchasing power over other currencies, *i.e.*, it will be at a discount. Thus, the rate of exchange will fluctuate according to the excess of exports over imports and *vice versa*. In other words, the rate of exchange will rise and fall

according to the balance of trade This is the well known Balance of Trade Theory as the determinant of foreign exchanges.

Items composing Balance of indebtedness — In actual practice, however, the rate of exchange does not depend only on the visible merchandise transactions of a country but upon all kinds of its debits and credits comprising both *visible* and *invisible exports and imports*. Moreover, the rates of exchange are not determined by the dealings between two countries only, but the dealings of one country with all other countries, with which it deals, are taken into account. (Visible exports and imports refer to the merchandise trade transactions like goods, commodities, and wares, and bullion which are entered in the statistical records of exports and imports, whereas invisible imports comprise those items of international dealings which are not recorded in statistical returns of trade, but which must be included in the calculations of the total debits and credits between different countries to arrive at the real balance of indebtedness or payments between them.) In addition to merchandise transactions, the Balance of Indebtedness is composed of freight, commission, brokerage, premium etc, for the services of shipping, banking, finance and insurance companies of one country render to another, & of services of floating loans and buying and selling of stock exchange securities, of arbitrage

operations of banks,¹ of expenses of foreign tourists, students and visitors,² of letters of credit and notes, accommodation and clearing bills, of pensions and payments from the nationals of a country resident abroad, of payment and receipt of deposits, interest, dividends and profits on capital invested in foreign countries, and of payments and receipts on capital accounts, charities tributes, indemnities and purchase of stores (The repercussions of all these items on the balance of indebtedness or payments are just like ordinary exports and imports of merchandise) Thus, in the words of *Angas* "In a foreign exchange market, demand (for money) arises not only from the importation of goods, services or securities, but also from the service of political and other debts, from desire to speculate in foreign currencies, from desire to travel, from the purchase of lands, houses and factories abroad, from long and short loans to foreigners, from presents and other remittances, and from a desire to export one's capital. Similarly, supply results not only from actual export of goods but also from the sale of securities, from the sale of financial, shipping and personal services, from dividends earned abroad, from short and long term borrowing, and from speculative purchase of currencies by foreigners (for a rise or for safety) "³

³The Problems of Foreign Exchanges

Ordinarily, taking the grand totals of visible and invisible exports and imports, it can be stated that the exports pay for the imports in the long run, because the course of trade of a country cannot for ever be in the same direction. The balance of the mutual indebtedness between two countries is adjusted by *free flow of specie* to and fro. This *free movement* leads to changes in the supply of money and affects the price level and through the price movement corrects automatically excess of export over imports and *vice versa*. For instance, if the exports of a country are greater than its imports, the favourable balance of trade will cause an inflow of gold into it (Gradually this gold will permeate into circulation, provided it is not frozen or sterilised,) and the resulting inflation of currency will cause its price level to rise higher than the world price level. It will become more profitable, therefore, to sell to, than purchase from, this country. Its exports will decline, imports will increase and, in the long run, the balance of trade will become unfavourable and cause an outflow of gold from it and the readjustment of the price level with the world price level. If imports are in excess the reverse effects will follow. In addition to this automatic correction of a rise or fall of exchange rate, exchanges may be corrected by currency reforms and by regulation of the Bank Rate of Discount. The

outflow of gold from a country lessens the bank reserves and an inflow of it strengthens them, with the diminution of the reserves, the rate of discount rises, and with an increase of the reserves, the rate of discount falls. These rises and falls in the rate of discount counteract the flow of gold in huge quantities and affect thereby the rates of exchange.

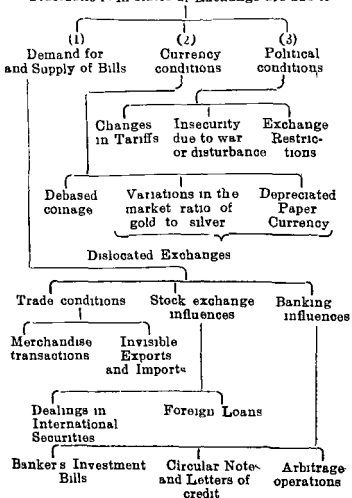
✓ If an adverse balance of payment continues for a long time it may be corrected either by exchange depreciation by charging a higher price for foreign bills in domestic currency or by deflation through a reduction of banks' 'cash' and advances and the raising of the bank rate or through devaluation or restriction of imports in various ways and stimulation of exports or through control and regulation of foreign exchange.

For the sake of convenience and for a better grasp of the technicalities of causes of fluctuations, the various factors, which influence the rise and fall of rates of exchange, may be grouped, following the method adopted by E. Sykes, into three broad heads —

- (a) The demand for and the supply of foreign bills or currency as compared with the home currency which depend upon trade, banking and stock exchange conditions,
- (b) Currency conditions both home and foreign, and

(c) Political conditions affecting trade, banking and currency conditions.
This may be represented in a form as follows

Fluctuations in Rates of Exchange are due to



We have already explained the operations of the trade conditions. The invisible exports and imports have similar effects to those of visible exports and imports. Any kind of service rendered by a country is just like an export from it and is reckoned on the credit side of the Balance of Account, whereas it is like an import to the country receiving that service. It makes the exchange favourable to the country rendering the service and unfavourable to the country receiving it.

As regards *banking conditions*, if the operations of the banks of a country cause funds to flow into it the demand for the home currency rises and therefore its value rises in comparison with the foreign currency. A rise in the Bank Rate for example will attract funds from foreign countries into the home country, therefore the value of the home currency in foreign exchange would rise. A fall in the Bank Rate would have an opposite effect. If letters of credit and travellers' cheques or Circular Notes are issued by the banks of the home country to travellers going abroad, the effect will be like that of imports because such cheques and notes etc. create a claim of the foreign bankers to whom these forms of credit are addressed against the banks of the issuing country. Hence, they create unfavourable exchanges for the issuing country and favourable for others. Similarly, if a country grants a loan to a foreign

country it creates claims of the grantee to draw against itself and therefore the exchange will be unfavourable to the country issuing it. When interest or the principal is paid then the effect is opposite.

As to *the stock exchange conditions* when the people of the home country purchase foreign stocks and shares, the demand for the foreign currency rises and so does its value as compared with the home currency, and when its people sell such securities, there is an increased demand for the home currency, and therefore, a rise in its value, as compared with the foreign currency, takes place. On the other hand, if foreigners buy the securities of the home country, the demand for the home currency increases and its value rises in comparison with the value of the foreign currency, and when they sell them, the demand for the foreign currency increases and its value rises relatively to the currency. Thus, the stock exchange operations will influence the balance of indebtedness and the rate of exchange.

Besides these factors, which influence the demand for, and supply of, bills and cause variations in the rate of exchange, currency depreciation in the home and the foreign country also affect the rate of exchange. Debasement of coins, over issue of paper money and consequent depreciation and changes in the ratio of gold and silver

influence the rate of exchange. The country, with greater over-issue of paper money and consequent greater depreciation of its currency, will have unfavourable exchanges because its currency will have a depreciated value in foreign exchange also. There are no limits to fluctuations* in the rate of exchange as between two countries which have inconvertible paper money standards. Debasement of currency will also mean a greater debt burden in home currency and will therefore cause adverse exchanges.

Similarly, political conditions by changing the trade relations through tariffs, quotas and restrictions or subsidies and bounties influence the course of trade and therefore the rate of exchange. Political unrest, strikes, wars and the consequent uncertainties result in wide fluctuations of exchange and lead to speculative dealings. They also bring about changes in currency conditions and hence influence the rate of exchange powerfully.

* Dislocated exchanges resulting from paper money issues give peculiar opportunity and temptation for speculation. A bill on a country whose paper is depreciated ceases to give a command over gold, and its value is no longer anchored to a fixed position. It gives command only over goods purchasable in the country on which it is drawn. All this leads to violent fluctuations in the exchanges. International trade with such a country becomes pure gambling and speculation. *Taussig* op cit p 464

Explanations of Terminology of Exchanges

Favourable and Unfavourable Exchanges — The favourableness or otherwise of a rate of exchange is *judged mostly from the view point of importers*. A favourable rate of exchange, therefore, is unfavourable to the exporters and *vice versa*. *When the price of a foreign bill is quoted below mint par in the currency of the home country the rate of exchange is said to be favourable to it*. In other words, when a given amount of the home currency metal will purchase a larger amount of the money metal of the foreign country the rate of exchange is said to be favourable to it. It is regarded favourable by the businessmen because it leads to imports of bullion or gold from abroad and lower rates of interest. Obviously, it will happen when the exports of the country are greater than the imports and the demand for the foreign paper in it is less than the supply. On the other hand, *when the price of a foreign bill is quoted above mint par in the home currency of a country, then the exchange is said to be unfavourable to it*. In other words, when the home currency metal in a certain quantity can be exchanged for a smaller amount of the foreign currency metal it is said to be unfavourable. It leads to export of bullion or gold and to higher interest rates and will happen when the imports of the country are greater than its exports. In other words, *when the rate is quoted in home currency, a rate below*

mint par is favourable to debtors or importers and a rate above mint par is unfavourable

When the rate is quoted in foreign currency, then a rate below mint par is said to be unfavourable while a rate above par is said to be favourable Or, in the words of G Clare from the point of view of an English debtor, when rates are quoted in foreign currency, "*high rates are for us and low rates against us*"⁷ If the rates are quoted in sterling the opposite of it will be true. This idea of favourable and unfavourable exchanges has been badly criticised by economists as false and misleading and as reminiscent of the mercantilist theory, the myth of which was long ago exploded by Adam Smith. However, higher exchanges leading to cheap money, low rates of interest and low bank rate and a strengthened reserve enable the business community which is usually a debtor community to get trade capital at cheap rates and therefore they are regarded favourable by them, and a lower exchange having opposite effects is regarded as unfavourable. *When gold flows in exchanges are favourable, when gold flows out they are unfavourable*

"Buy high, sell low, the better the bill, the

⁷ E Sykes "When the rates are quoted in foreign money to the pound sterling high rates are favourable to us, low rates unfavourable. When the rates are quoted in shillings and pence in the foreign units high rates are unfavourable low rates are favourable"

lower the rate":—When rates are quoted in foreign currency, a rise in the exchange is for the country, and a fall or lower rate is against it. For example, when the rate of exchange in India is 1s 6d to a Rupee then to pay a debt of £1 an Indian debtor will have to pay only Rs 13/5/4 in his own currency, but when the rate is 1s 4d, to clear the same debt he will have to pay Rs. 15 in his currency and therefore he gains to the extent of Rs 1/10/8 per pound of debts when it is 1s. 6d. Hence, *the debtor should buy high*. But, *the creditor should sell low* because in that case he will get more of his own currency for every pound of his credit. For example, if the rate is 1s. 4d. the creditor will get Rs. 15 for £1 and when it is 1s. 6d he will get only Rs 13/5/4. In this way he shall lose Rs 1/10/8 per pound of his claims against the alien. *If the rates are quoted in the home currency, then this maxim is reversed. "Buy low sell high, better the bill, higher the rate"*—this statement will hold good, a low rate will be for the country and a high rate will be against it.

Sight or Short Exchange and Long Exchange —Sight exchanges refer to the rates for short bills, sight drafts and cheques and are called short exchanges as distinguished from the long exchanges which refer to the prices of bills payable ordinarily three months after the day of purchase. Either of them can be determined from the other. Sight exchange on two sides is usually the

same *i.e.* it cannot be rising in one country and falling in the other at the same time, but the long rate may be rising in one country and falling in the other at the same time. Long rate is composed of the sight rate plus 3 months' interest at the foreign rate plus foreign bill-stamp, plus some allowance for contingencies

Forward Exchange —The widespread fluctuations in the rates of exchanges during the post-war period have led to dealings in futures of exchanges like dealings in futures on the produce exchanges. The chief object of such dealings is to safeguard traders against losses caused by quick and wide fluctuations of exchange rates, between different countries due to unsettled monetary and political or banking conditions. The bankers by dealings in in such forward exchanges *i.e.* buying and then selling, distribute the risks of such losses on as many of them as possible and through constructive speculations stabilise the rates to the benefits of traders. These dealings enable the bankers to minimise the risks of losses and to get themselves insured against such risks

Tel quel rate is the price of a bill adjusted in such a way as to make it agree with the term of the bill. It is the net price of the bill or its price "as it is". A *Tel quel rate* is mostly found in case of sterling bills payable at the endorsed rate of exchange

If, for example a bill is drawn for three months and it has already run two months of its term, then the rate of the bill as it is for one month is *tel quel* rate. In other words, *tel quel* rate is the adjusted long rate of a bill which has run some part of its term.

Arbitrage Dealings —It has been pointed out, while describing the operations of bills of exchange, that sometimes it is more profitable to make a round-about payment to a foreigner than to do so directly, on account of variations in the rates of exchange of the same currency in different centres at the same time. For example, a debtor in America on account of differences in the rates pays to his London creditor not directly but, say, through Berlin. In this way a new rate between New York and London is established and this new rate is called *arbitrated rate* or *arbitrage*. It may be *simple* or *compound*. If only one intermediate centre is tapped, the arbitrage is simple, and if more than one intermediate centres are used, it is then compound.

Purchasing Power Parity Theory

When two countries in trade relations are off the gold standard what determines the rate of exchange between them? The answer is the relative purchasing powers of the two currencies in terms of commodities of international consumption within their countries. As Mr Cole has put it "The relative values of nat 1-

currencies which are off gold are determined in the long run mainly by their relative purchasing powers in terms of goods and services"* According to the old theory, the rate of exchange is settled by the balances or payment or credits and debits During the Great War a huge quantity of inconvertible paper money was used in practically all the countries of Europe This resulted in a heavy rise in prices, but the rise in prices consequent upon the inflation of currencies, was not uniform in the different countries. Russia and Germany were the worst sufferers and England, France and Italy also had immense quantities of inconvertible paper Under these circumstances, the rates of exchange between the different countries, according to Prof Gustav Cassel of the Stockholm University, are not determined by the balance of trade as in the past but by the relative price levels in the two countries The degree of inflation between them is the most potent factor influencing the exchange rates Because the parity of exchange depends upon the purchasing powers of the currencies as indicated by the price levels, therefore, it is called Purchasing Power Parity However, unlike the mint par it is not a fixed but constantly changing, or moving par of exchange, varying with the changes in the price levels of the countries

* 'What everybody wants to know about Money'

Cassel, after stating that the desire for foreign money is due to its purchasing power, has put it as follows, "When two currencies in two countries have been inflated, the new normal rate of exchange will be equal to the old rate multiplied by the quotient between the degrees of inflation of both countries. There will, of course, always be fluctuations from these normal rates and, in a period of transition, these fluctuations are apt to be rather wide. But the rate calculated in the way indicated must be regarded as the new parity (or par of exchange) between the currencies. This parity may be called the P P P, as it is determined by the quotient of the purchasing powers of the different currencies' *"

The Theory may be illustrated very simply. Take two countries each of which has a standard gold coin of equal weight and fineness *e g*, England and Australia. The parity of exchange between them will be unity—one unit of the currency of one shall be equal to one unit of the currency of the other. Then suppose both of them introduce inconvertible paper standards and inflate their currencies, but the currency in one is doubled and that in the other is quadrupled. Then the price level in the first is doubled and in the second it becomes four-fold. Then the parity of exchange

*The World's Monetary Problems

between the two currencies shall now be 1 2 i. e., one unit of the first will be equal to two units of the second

The theory, however, is not a new enunciation but it is a repetition of the same principle of parity of exchanges between different currencies with this difference only that formerly the parity was determined by reference to an international standard of value i. e. gold, whereas now it is determined by reference to the prices of different commodities in general consumption. There were two broad distinctions between the pre-war and the post-war exchanges *viz* all countries had depreciated paper currencies and unlike prewar days gold had fallen in purchasing power, and ceased to be an international standard of value and became a commodity.

Thus, the value of the paper unit of one country in terms of another is settled by the relative values of the two units in terms of goods and services as indicated by the index numbers of prices between the two countries.

Calculation of the parities —To arrive at the parities of exchange we take into consideration the extent of depreciation of the paper currencies in their countries as indicated by the index numbers of prices in them. Then the old rate i. e. mint par is multiplied by the index number of the country in whose currency we want to

find out the rate and divide the product by the index number of the other country,*
e g in 1913 £1=4 866 dollars and between 1913 and 1919 English prices had risen by 56% *i e* the index number had risen from 100 to 156 and the American prices rose by 48% *i e* from 100 to 148, and we want to know how many post-war dollars shall be equal to £, then we get it as below

$$£1 = \frac{4\,866 \times 148}{156} \text{ or } 4\,616 \text{ post-war dollars}$$

Thus, the P. P. P. may be defined "as that rate of exchange which at any given time makes the purchasing power of the one currency equal to that of the other" Or "When two currencies have undergone inflation, the normal rate of exchange will be equal to old rate multiplied by the quotient of the degree of inflation in one country and in the other."†

Criticism — The theory holds good only in the long run and not in periods of transitions. It cannot satisfactorily interpret current fluctuations in exchanges. It takes

* The purchasing power parity between any two currencies is obtained by multiplying the current index number of prices in the country in whose currency the figure is to be expressed by the pre War par of exchange in order to make the two index numbers of prices comparable and dividing this result by the current index number of the second country.

Chabani Indian Currency, Banking & Exchange

† Cassel Op cit,

into account only monetary changes and tries to explain their repercussions on the exchange rates, assuming that other conditions remain stationary, but if they are not so, as actually they are not, then the theory does not hold good "If something happens to disturb the conditions of demand for exports or imports of any invisible items etc, which disturbs the barter terms of trade, then the P P P doctrine does not hold good"† It is not a fixed par, like mint par, because it depends on the magnitude of two index numbers which change and the deviations from it will not be automatically adjusted like that of the mint par. Then the theory is based on index numbers of prices which at best are averages and are prepared for the past months. By the time that indices are prepared and parities fixed, the price levels may move beyond. This difficulty becomes greater in periods of rapidly changing prices. Moreover, all prices do not rise uniformly and do not exert the same influence on foreign exchanges and the theory works only in terms of a few commodities which enter freely into international exchanges. Then, not only the movement of goods but also of services and capital, as we have already discussed, influences the rates of exchange but this theory ignores them and hence it is imper-

† *Clare and Crump*

fect. Because the index number is not an absolutely correct measurement of changes in the value of money, it is not a real rate of exchange unlike the mint par, and cannot be calculated accurately. In periods of wide changes in rates of exchange which impede trade and prevent goods from finding their true level of prices in every country the theory is not a clear guide. The volume of trade under such circumstances cannot be found out. Political influences and artificial restrictions upon trade, movement of gold and exchange control further increase the difficulties and make the theory extremely complicated and subject to various qualifications. Majority of the commodities employed for preparation of index numbers are raw materials and food-stuffs but foreign trade comprises manufactured goods as well, whose cost of production depends, besides raw material, on wages and other costs which lag behind prices. Moreover, allowance has to be made for export and import duties and transport charges without which the deviation from the parity will be great. To conclude : the P. P. P. theory is only a rough guide at best in the long run, it cannot be determined precisely, calculated accurately and exchange rates cannot exactly conform to it. It cannot be applied as a complete mathematical formula and works out best when two depreciated paper currencies

preserve some degree of stability and have not fallen too much in their purchasing power "Still, the theory of P P P, with the later concepts of overvaluation, and under-valuation serves to provide a rough guide to what is happening and helps to explain in part what has happened during recent years It is neither a complete nor a mathematically correct theory of exchanges, but it is necessary to know the theory in order to understand what has been happening in the world in recent years and today"*

The theory has, for example, been recently applied to the determination of the rupee sterling exchange by the Babington Smith Committee and the Hilton Young Commission. On the pre-War base of 100 in 1914 the Indian price level rose to 178 in 1919 while the English price level rose to 226, and therefore the new rate of exchange was fixed at 20d. ($\frac{16d + 226}{178} = 20 \text{ 3d.}$) Both in 1920 and in 1925-26 the rate was fixed at 2s and 1s. 6d. respectively with reference to the Indian and the English price levels.

**Clare and Crumps*: A. B. C. of Foreign Exchange, p. 149

CHAPTER XV

INDIAN CURRENCY SYSTEM (1793—1914)

At the beginning of the last century there was no uniform standard of value throughout British India. In the north both gold and silver coins circulated together without any fixed legal ratio between them, but the Mohammedan Kings preferred the silver rupee coins. In the south the Hindu Kings had adopted the gold pagoda as the standard of value. The exchange value of the two standard coins (the gold mohur and the silver rupee) was determined by their relative weight and fineness. H. D. Macleod in his "Indian Currency" recalls that the E I Co found 994 kinds of gold and silver coins of varying weight and fineness, and their value was constantly changing from day to day. Moreover, their value being uncertain, the services of a professional money changer or shroff were necessary to determine the value of each coin even for moderate payments. A Bengal Regulation of 1793 mentions no less than 27 varieties of rupees in the several districts. This rich variety of gold and silver coins caused a good deal of inconvenience to trade and business, made the collection of revenue difficult and rendered

the Indian currency system a *currency by weight*. To avoid this inconvenience and heterogeneity, the E. I. Co. tried to issue both gold and silver coins with a fixed legal ratio between them. But on account of the constant fluctuations in the market ratio of the metals, this bimetallic standard ended in a failure due to the Gresham's law.

Establishment of Silver Monometallism — In the year 1806 on the publication of Lord Liverpool's 'Coins of the Realm' the Governor-General-in-Council favoured the establishment of a silver mono-metallic standard. In their despatch of 25th April 1806, the Board of Directors wrote to the Governments of Bengal and Madras that they were fully satisfied with the propriety of the silver Rupee being the principal measure of value and the money of account. They further proposed to coin a gold Rupee of the same weight and fineness as the silver coin without any fixed ratio between them.

In 1818 the Madras Government adopted a new coinage of gold and silver. The Hindu gold pagoda was replaced by the silver Rupee as the standard coin at a rate of 180 grains $11/12$ fine, but both gold and silver were declared to be equally legal tender, because, although the coinage of the pagoda was stopped, gold coins could still be tendered and received at all the public offices to suit the convenience of the

public at such rates as were to be determined from time to time. The Government, therefore, still persevered in the vain attempt to maintain bimetallism. The inconvenience of weighing the coins as bullion in making payment continued unabated because the various Presidencies had Rupees of different weight and fineness, so that the Rupee of one was not legal tender in the other. In 1823, the Bombay Rupee was made identical with the Madras Rupee and finally in 1835 the Indian Rupee in its present form and weight was issued which was identical with the Madras Rupee of 1818. Thus, by 1835 the E I Co. succeeded in giving the much needed uniformity to the currency system by making the silver Rupee uniform legal tender. The coinage Act of 1835 established the silver Rupee of 180 grains $11/12$ fine as the standard coin and legal tender throughout British India, and enacted that no gold coin in future should be legal tender in any part of British India. Mints were opened to the free coinage of silver, the Indian currency system became a silver standard and remained so till 1893. But the Act of 1835 authorised the issue of gold mohurs of 15 rupees pieces of the same weight and fineness as the Rupee, and 5, 10, and 30 Rupees pieces of the same standard as the Gold mohur.

Hence, by 1835 bimetallism was supplanted by silver mono-metallism. Gold ceased

to be legal tender as between individuals but the provision for coining gold mohurs did not entirely discourage their use by the public

Demonetisation of Gold

In the next period of the history of Indian currency constant changes in the value of gold and silver in terms of each other made the maintenance of the stability of the Rupee a very difficult problem and, therefore, it is characterised by experiments. Between 1853—74 gold was demonetised after attempts at introduction of gold coins had proved failures. As adverted to above, the Government had issued a proclamation in 1835 authorising the public treasuries to receive freely gold mohurs in the ratio of 15 : 1. The discoveries of gold in California and Australia in 1848 and 1849 led to an abnormal increase in its supply and it depreciated in terms of silver. People began to make payments in gold, and the Government had to withdraw their proclamation of 1841. After 1850 the production of silver did not keep pace with its demand and there was a great scarcity of money in the market. Businessmen began to demand a gold currency, and in 1864 a notification was issued, authorising the treasuries to receive sovereigns and half-sovereigns at the rate of Rs 10/- and Rs 5/- respectively. The Mansfield Commission of 1806 recommended the issue of gold coins

of the face value of Rs 15, 10, and 5 and a mixed currency of gold, silver and paper, but no action was taken by the Government in this behalf. Then in 1868 the rate for sovereigns and half-sovereigns was raised to 10/4/- and 5/2/- respectively. In 1872 Sir Richard Temple suggested a gold currency and urged the appointment of a Commission, but the Government rejected the proposal in 1874.

Efforts to Re-establish Bimetallism

In the meantime a new factor of disturbance from 1873 onwards had appeared. It was the heavy fall in the price of silver and the accompanying Great Depression. From 1816 the Gold Standard was gradually adopted by all the leading European countries and America and from 1865 the Latin Union in Europe had been trying very hard for the adoption of an international bimetallism. In the France-Prussian War of 1870 Germany was victorious and she celebrated her triumph by demonetising silver and adopting a gold standard. This let loose a huge quantity of silver on the market at a time when its demand for monetary purposes was declining all round except in China and India. The supply of silver was also increased by its manufacture from lead. It became a drag on the market and its price therefore fell very heavily. At the same time the price of gold was rising. This dislocated the foreign exchanges of

those countries which were on a silver basis and disorganised their foreign trade. With the depreciation of silver, the gold value of the Rupee was falling heavily so much so that exchange fell from 2s gold in 1871 to about 1s 2d in 1892. Silver was being imported in huge quantities and its heavy coinage sent up prices in the country to a great extent. The Government of India was suffering heavy losses in finances and exchange and their ways and means operations were badly upset. An agitation for closing the mints to the free coinage of silver grew up and the demand for the establishment of gold standard became more insistent. The Government of India sent regularly its representatives to the international conferences in Europe for the advocacy of an international bimetalism but nothing came out of these pilgrimages. The scheme for an international bimetalism fell through mainly on account of the opposition of England. In 1878, the Government of India proposed a gold standard to the Secretary of State, but the British Treasury to which the matter was referred by the Secretary of State advised the Government of India to sit still and do nothing in a spirit of panic which might cause repentance later on.

The continued fall in the price of silver led to the repeal of the Sherman Act by the Government of U S A, under which the American Government was purchasing 54

million ounces of silver annually. As a result of this the position of the Indian Rupee became still more precarious and in 1891 the Government of India again approached the Secretary of State with the proposal of suspending the free coinage of silver and of adopting a gold standard, if the Brussels Conference, which was then sitting, did not succeed in evolving a universal bimetallism.

Herschell Committee and the Stoppage of Free Coinage of Silver

This led to the appointment of the Currency Committee of 1893 presided over by Lord Herschell. The proposal of the Government of India was referred to this Committee for investigation and report. The Committee approved of the proposals of the Government of India with certain modifications. They recommended the suspension of the free coinage of silver. In fact there was to be no free coinage of either gold or silver; the Rupee was to continue to be full legal tender and gold was to be used only partially for currency purposes during the transitional period after which a gold standard was to be established. The chief objects of these recommendations were to safeguard the Rupee against the fall in the price of silver, to stop the fall in the exchange value of the Rupee, to encourage the import of foreign capital for the development of railways, irrigation

and other productive enterprises, to discourage the imports of silver and to familiarise the people with the use of gold sovereigns with a view to their ultimate introduction and linking of India with the gold standard countries. The Committee thought that a period of transition was necessary before the establishment of the gold standard.

The recommendations of the Committee were accepted by Her Majesty's Government and in 1893 an Act was passed to amend the Coinage Act of 1870 and the Indian Paper Currency Act of 1882. The Indian mints were immediately closed to the free coinage of silver but the Government retained the power to coin Rupees on their own account. On 26th June 1893, notifications were issued to arrange for (a) the receipt of gold at the rate of 7.53344 grains of fine gold per Rupee (b) the acceptance of sovereigns and half-sovereigns at Rs 15/- and Rs 7/8/- respectively, and (c) the issue of currency notes in exchange for sovereigns or gold bullion.

As expected, the closing of the mints to the free coinage of silver led gradually to a rise in the exchange value of the rupee and by 1898 the rate of exchange rose to 1s. 4d. In 1898 the practice of selling Council Bills for gold in London, and issuing notes against such gold in India, was introduced with a view to finance the

export trade and to prevent the flow of excessive gold to India, although its declared object was to enable the Secretary of State to get funds for the Home Charges

Fowler Committee and Gold Standard

The objects of the currency policy of 1893 having been achieved a new Committee was appointed in 1898 to investigate and report upon the effectiveness of this policy and the introduction of a gold standard which was the declared object of that policy. The Committee examined the various proposals for currency reform and rejected the schemes of the Government of India and that of Mr Lindsay. The re-introduction of silver mono-metallism after the adverse influences of the fall in the price of silver was unthinkable. Mr Lindsay's scheme envisaged a gold exchange standard which was rejected by the Committee on various grounds. Similarly the tentative proposals of the Government of India with a view to an ultimate introduction of gold standard were rejected chiefly on the ground of bad effects of the deflation of currency which the scheme involved.

The chief object of the recommendations of the Committee was the introduction of a gold standard with gold coins into active circulation. To attain this end the Committee recommended (a) the continuance of restricted coinage of silver and unrestricted

coinage of gold for which a mint was to be established (b) that Sovereigns were to be made a current coin and legal tender and were to circulate side by side with silver Rupees at the ratio of Rs. 15 to a Sovereign or 1s 4d to a Rupee (c) that the Government should be under no obligation to give gold for internal use (d) that all profits on coinage of Rupee were to be earmarked into a special reserve called, the Gold Standard Reserve, and should not be frittered away on the development of railways etc, or merged into the general revenues of the Government This reserve was to be kept in gold to maintain the exchange value of the Rupee at 1s 4d gold, and (e) that no fresh coinage of silver was to be undertaken till the gold exceeded the requirements of the public

Although the Committee had in view a gold standard, yet their tentative recommendations for its ultimate establishment brought into existence a Limping Standard under which both gold and silver were unlimited legal tender but mints were open to free coinage of gold only

The Government of India professed to accept all the recommendations of the Committee but, when it came to practise them, they were observed more in breach than execution The Coinage Act of 1899 made sovereigns and half-sovereigns legal tender throughout British India at the rate of

Rs 15 to the £. They created the Gold Standard Reserve in 1900 out of the profits on coinage of Rupees and made an attempt to issue sovereigns for which a branch of Her Majesty's mint was opened in Bombay. They also notified to the railways to assist them in their efforts to introduce a gold standard by receiving and paying gold. But on account of the severe famines in 1899, 1900 and 1901, the sovereigns did not circulate and were returned to the treasuries. Then against the recommendations of the Committee silver coinage was re-adopted for public need in 1899-1900. After this no attempt was made to familiarise the people with the use of gold and the Government came to the astounding conclusion that the Indian people preferred the silver Rupees to the gold sovereigns and hence dropped the idea of a gold mint in 1902. A *second serious departure* from the Committee's recommendations was that the profits on coinage were not earmarked into the special reserve, as recommended, but were utilised for famine relief, and in 1907, in pursuance of the Mackay Committee's recommendations, one million pounds were spent on the capital programme of the railways and later on one half of the profits were spent on railways till G S R reached £ 20m. *Thirdly*, the whole of this reserve was not kept in gold, but a part of it was invested in short-term sterling securities and the gold was placed in

London because the Secretary of State refused to allow the Government of India to keep it in India. A silver branch of the G S R was formed and kept in Rupees in India. In 1904, the Secretary of State declared his intention to sell Council Bills without limit at 1s 4½d which was the gold export point from London to India. Then in 1907 & 8 to meet the requirements of the import trade, caused by a failure of the monsoons, the Government of India, at the instance of the Secretary of State, declared their intentions to sell Reverse Councils on London at 1s 3¾d per Rupee. Very often C Bills were sold below gold point against the Paper Currency Reserve and the flow of gold into India was prevented. The gold in the P C R was used for the purchase of silver for coinage. In 1909 the Government of India wanted to keep a Paper Currency Reserve of 9m sovereigns but the Secretary of State opposed it on the ground of stringency in the London Money Market. In 1912 they made a proposal for the establishment of a branch of the Royal Mint but it was not till the Great War that the Bombay mint was made a branch of the Royal Mint. A perusal of the despatches of the Government of India and the replies of the Secretary of State thereto brings out clearly the fact that the Government of India made constant appeals to the Secretary of State for the introduction of a gold currency but the latter,

together with the British Treasury and the "City of London", maintained a firm attitude of opposition.

Thus was evolved, by administrative practice, the system of the Councils and the Reverses which form even to-day the key-stone of the Indian currency system. In the place of the gold standard with gold coins into active circulation, as recommended by the Fowler Committee, the Gold Exchange Standard came into existence and continued till 1917 when it broke down on account of the abnormal conditions of the War

In the meantime the currency and exchange policy of the Government of India had led to carping criticism from Indian publicists and businessmen. The chief criticisms were

- (1) that it transferred from India to England an immense block of India's resources aggregating over £70m. where they were lent out at low rates of interest to the London bankers, while India was starved of money until at one time there was no money available for loans even against Government Securities and the bank rate was artificially high,
- (2) that the unlimited, and at times below the gold point, sale of Councils Bills prevented the free flow of gold

to India to liquidate her normal favourable balance of trade ,

- (3) that the sale of Reverse Councils in 1907-8 caused a loss of £8 to £9 m of gold in the attempt to raise the exchange value of the Rupee ,
- (4) that the Gold Standard Reserve was invested in sterling securities in London instead of being kept in India ,
- (5) that it was utilised for railway capital expenditure ,
- (6) that a large sum of the Paper Currency Reserve was transferred to London ,
- (7) that a silver branch of the G S R was formed to facilitate the coinage of Rupees , and
- (8) that token Rupees were forced into circulation in excessive quantities

And all this was done, it was alleged, at the dictation of the small Finance Committee of the India Office under the direct influence of the "City of London" When the Government purchased silver for coining Rupees through Montagu & Co, instead of the Bank of England, a hue and cry was raised and a series of articles appeared in the "Times" criticising the Government currency policy While the Government had ignored throughout Indian criticism they could not ignore this criticism from

London Moreover, as noted above, there was a sharp difference of opinion between the Secretary of State and the Government of India with regard to the quantity and form of the G S R and holding of a large amount of gold in India in the P C R and the coinage of sovereigns Under these circumstances, a Royal Commission under the chairmanship of Mr A Chamberlain was appointed in April 1913 and its report is reported in February 1914 This is known as the Chamberlain Commission

Chamberlain Commission

The Commission examined in detail the working of the Indian Currency System since 1893 and the majority concluded that it was unnecessary for the maintenance of the exchange value of the Rupee at 1s 4d to have a gold currency and that, unlike the belief of the Fowler Committee, it was possible to have a gold standard without a gold coin in active circulation It was not to the advantage of India to have a gold currency which was less effective than gold in reserve for supporting exchange, and its introduction would militate against the use of notes which was a more desirable form of currency and gold would be wasted because of the hoarding habit They were also not in favour of opening a gold mint in India, but stated, that if Indian sentiment genuinely demanded it, and the Government was prepared to incur the

expense, they had no objection to the gold mint on principle, provided the coin to be minted was the sovereign or half-sovereign. The finding of the Commission was that, although the Gold Exchange Standard was evolved through administrative practice, and as a result of a series of experiments, yet, it was a sound and efficient system. The majority therefore patted the Secretary of State and the Government of India on their backs for evolving the 'limping standard', and maintaining the exchange value of the Rupee (in 1907-08) at 1s 4d through the mechanism of the Council and Reverse Councils and preventing an excessive accumulation of gold in India, and recommended that this system should continue. Sir James Begbie, the only Indian Banker on the Committee, submitted a strong minute of dissent and urged that "the true line of advance was to discourage the extension of the token money by providing further facilities for the distribution of gold when increases to the currency became necessary, including the issue of an Indian gold coin of a more convenient denomination than the sovereign or half-sovereign."

With a view to strengthen the stability of the exchange value of the Rupee and to the perfection of the Gold Exchange Standard the majority recommended

That the internal currency (notes and rupees) should be supported by a thoroughly

adequate reserve of gold and sterling, that the G. S. R. should be strengthened by crediting all profits on coinage to it and by fixing no limit to its amount, and that half of it should be held in gold and its Rupee branch should be abolished, that Reverse Councils should be sold on demand at 1s. $3\frac{2}{3}$ d per Rupee, that the Paper Currency should be made more elastic by increasing the fiduciary portion from Rs 14 crores to Rs 20 crores at once, and thereafter, by fixing a maximum equal to the amount of notes held by the Government in the Reserve Treasuries plus $\frac{1}{3}$ of the net circulation and by making temporary investments or loans from the fiduciary portion within this maximum in India and in London as an alternative to investment in permanent securities, and that if no gold mint was opened then the notification to receive refined gold in exchange for Rupees or notes at the Bombay mint should be renewed.

While the Government were considering the report of the Commission, the Great War broke out and interfered with their giving effect to these recommendations. But some immediate steps were taken soon after the starting of the War *viz*,

- (a) the silver branch of the G. S. R. was abolished;
- (b) steps were decided to be taken in case of fall of exchange;
- (c) facilities were given for the encashment of notes.

CHAPTER XVI

Indian Currency (*Continued*)

The Great War (1914—1919)

The Great War caused a tremendous blow to the currency and exchange systems of the whole world, and although India was so far away from the theaters of War, she could not escape the blighting effects of that armageddon. At the time the War broke out the Indian currency system was firmly established, on the Gold Exchange Standard the salient features¹ of which were —

- (i) That the currency consisted of silver rupees and currency notes together with the sovereigns* and half sovereigns as unlimited legal tenders at the rate of Rs 15 to £1 or 1s 4d to the rupee and subsidiary coins for small payments
- (ii) That the rate of exchange was pre

¹For a detailed account see Chapter XVIII

*Ordinarily they did not form part of the internal circulation but were available at the scheduled rate for payment abroad. The rupees and the notes were not convertible into gold for internal purposes and even for external purposes the Government had an obligation to convert them either into gold or into foreign exchange at their option and convenience

vented from rising above gold import point *i.e.*, 1s 4½d by the unlimited sale of Council Bills at gold point London, and it was prevented falling from below the gold export point *i.e.*, 1s 3⅔d by the unlimited sale of Reverse Councils or Sterling bills in India. The Councils were paid out to exporters in India in rupees and notes at the Government treasuries and the funds paid for them by foreign importers of India produce accumulated in London with the Secretary of State on behalf of the Government of India, out of which the Reverses were paid in London to the foreign exporters.

- (iii) That a Gold Standard Reserve was maintained partly in England in gold and sterling securities chiefly and partly in India in silver and rupee securities mainly to enable the Secretary of State and the Government of India respectively to meet the Reverses and the Councils and thus maintain the rate of exchange.
- (iv) That a Paper Currency Reserve was also maintained for securing the convertibility of the notes mainly in silver coin, bullion and rupee securities in India and partly in gold coin and bullion and sterling securities in England.

Theoretically the two Reserves were designed to serve their specific purposes of maintaining exchange and convertibility of notes, but in practice their action was interlocked for the support of exchange and the gold and sterling securities in the P C R constituted the first line of defence against a demand for remittance from India. The location of the two Reserves partly in England and partly in India was extremely defective and expensive.

The Indian Currency System thus consisted of two tokens—the silver rupee and the currency note. The rupee was a Standard Token coin and was just like the currency note in all respects except its intrinsic value. It was in fact an inconvertible note printed on silver. The paper tokens were convertible into these inconvertible silver notes.

On account of the favourable balance of trade a sufficiently large quantity of gold and silver was imported into the country on private account.

War and its effects on Indian Currency and Exchange —During the stress and strain of the War this currency system completely broke down. For the sake of clarity of thought the effects of the War may be discussed in two parts viz —

(a) the first part beginning with the outbreak of the War and ending by 1916 i.e., 1914-16, and

(b) the second part from the commencement of 1917 to the end of the War and upto 1919

(a) 1914—16 —The problems during this period were the direct out-come of the Government ways and means difficulties and were to be accounted for

- (i) the loss of public confidence in the financial soundness and stability of Government amongst ignorant masses but chiefly among the Marwaris who were the prominent financiers of the internal trade and were influenced by a vague and unwarranted sense of insecurity, and
- (ii) the dislocation and depression of foreign trade, specially export trade, with its attendant evils which was the most out standing feature of the period. These were due to the panic of the war

The chief symptoms of this panic and general dislocation of trade and business were —

- (i) *the withdrawal of Savings Bank deposits,*
- (ii) *an unprecedented demand for the encashment of notes,*
- (iii) *a run upon the gold stocks, and,*
- (iv) *the weakening of the exchange*

The first three of these symptoms were the result of the panic and the consequent

loss of public confidence in the stability of the Government. The impatience of the Marwaris for the conversion of their capital into cash to be locked up in their iron safes in Rajputana aggravated the general position and hence, trade activities and internal credit suffered. The unusual run upon the postal Savings Banks resulted in a net withdrawal of Rs. 6 crores in the first two months of the War and there were subsequent withdrawals upto two crores upto 1916. But continuous payment restored confidence and the tide turned in 1915-16, from which date they began to increase and stood at $18\frac{3}{4}$ crores by the end of 1918-19 whereas they were $24\frac{1}{2}$ crores on the 1st of July, 1914. There was also a run on the banks but it lasted only for a short time.

When the war broke out there was some lack of confidence in the note issue and consequent widespread demand for encashment. This resulted in a net return of currency notes to the extent of 10 crores and there was consequently a substantial fall in the silver held in the Paper Currency Reserve *e g.*, the P.C.R. fell from 33.94 crores of rupees on 31st July 1914 to 29.87 crores of rupees on 31st December 1914; but from the spring of 1915 there was a steady increase in the note circulation.

There was a clamour for gold among the Marwaris in exchange for notes at

the end of July 1914, when the Government, to prevent its undue depletion, notified to issue gold to any person or firm in amounts of not less than £10,000 to distinguish between the demand for remittance and that for hoarding for internal requirements. But the Marwaris were too clever and they clubbed together to make up this minimum. Thus, within four days, (between 1st and 4th of August, 1914) the Government lost £1,800,000 worth of gold. Then they took precautions to discourage withdrawals of gold which, however, proved a failure, and on 5th August, therefore, the Government stopped the issue of gold altogether to private persons.

The weakening of exchange was due to the dislocation and depression of the foreign trade. To meet the situation the Government controlled the exchange, as they had done, in 1907-08, and improved upon it in some respects. They undertook to support exchange without any loss of time by all means in their power, and offered to sell sterling bills on London upto a limit of £1 m a week until further notice. To avoid uncertainty caused by delay in the arrival of these bills by mail steamer, they were paid in London 16 days after the departure of the weekly mail from Bombay and were sold to provide immediate and rapid remittance to London to those requiring it. The sale of these bills amounted to £8,707,000 between 6th

August, 1914, and 20th January, 1915 This amount was credited to the Gold Standard Reserve in India while the Bills and Transfers were paid in London out of the Reserve there Four million pounds of silver held in the Reserve in India were exchanged for an equivalent amount of gold held in the Paper Currency Reserve The applications exceeded £1 m limit in the first week, but in the second, they began to diminish gradually till they disappeared in January 1915 Thus, confidence was restored and the commercial community was assured of sufficient and continuous remittance facilities, and the absence of fear, as to the reduction of bills and transfers by the Government, eliminated speculative competition

In June 1915, however, the financing of the purchase of wheat on behalf of the Home Government and the demand for remittance of subscriptions to the Home War Loans caused again a fall in the exchange When these transactions were completed, trade activity brought about a reversal of exchange and a strong demand for Councils arose Some of these bills were paid out of the Gold Standard Reserve in India while the sums received in payment were credited to the reserve in London which regained strength in this way

These disquieting features of the first shock of War lasted only for a short time, and, with the readiness of the Government

to meet all demands, public confidence in the currency and exchange policy was restored and the currency system began to work smoothly. The Gold Exchange Standard displayed a great strength and the stability of the rupee was maintained. However, it was brought about by artificial measures, the rupee was virtually inconvertible into pure gold, its stability was only temporary and during the second period exchange proved a source of considerable embarrassment, anxiety and loss.

(b) 1917-19 —The second part of the War witnessed a *Partial breakdown of the Gold Exchange Standard, a progressive and abnormal rise in exchange, an unprecedented demand for silver coinage for financing the war work in India and abroad, a considerable inflation of paper currency, and a dislocation of the mechanism of Government finance and of trade finance also which revealed very clearly the intimate dependence of Indian trade, on the financial machinery of the Government of India.* The difficulties of the Government and of trade had two aspects—(a) *external relating to rise in exchange* and (b) *internal relating to the expansion of currency*.

External

Rise in Exchange Rate and its Causes — Towards the end of 1916, great and varied complications in the currency and exchange caused an unprecedented strain on the resources of the country. These compli-

tions arose from (a) *an enormous favourable balance of trade* (b) *the exceptionally heavy disbursements on behalf of the Allies, Dominions and Colonies for the purchase of food-stuffs and raw materials for the War* (c) *a heavy decline in the imports from the continental countries of Europe and* (d) *an abnormal rise in the price of silver* The upshot of all these complications was the exceptional rise in exchange and absorption of an enormous quantity of rupees and notes

The successful working of the Indian currency system and the ability of the Government of India to remit to London funds for the payment of the Home Charges had been dependent on a substantial favourable balance of trade. A substantial part of this favourable balance of trade took the form of import of precious metals by private agency, and, the remainder of the excess, that of the remittances which were sold by the Secretary of State to meet his Home Charges. India had enjoyed a series of very prosperous years even before the War during which this prosperity continued, though at a slightly lesser figure, *e.g.*, the average annual net exports in the period 1909-10 to 1913-14 were £52,237,200, whereas between 1914-15 to 1918-19 they were £50,387,700. But if we take into consideration the three years 1916-19, *i.e.*, the second part of the War, when the currency difficulties were very acute, the average balance of trade was decidedly greater than that

of the three years preceding the War, *e.g.*, it rose from £53,429,200, the prewar figure, to £59,601,100 or about £60 m. during 1916 19 on an average. This great rise in the exportable surplus was due to abnormally high prices during the War and to the vast supplies of food-stuffs and raw materials for the use of the Allied Powers. Simultaneously with this rise in export, there was a reduction in imports from Austria, Germany, Italy, France and United Kingdom, because the productive power of these combatants was completely absorbed in the production of war materials. It was only the high rise in prices that maintained the value of the import trade. This enormous balance of credit in India's favour caused a strengthening of the exchange rate and a heavy demand on the Government for the supply of currency.

Secondly, in addition to this favourable balance of trade, other special causes intensified this heavy demand for currency. India formed the base of important military operations in Mesopotamia, Persia and East Africa, where the Government of India had to provide funds for the payment of British and Indian troops and for civil expenditure in the occupied territories. In five years, this expenditure totalled £240m. Further arrangements had to be made for financing of purchases in India on behalf of the Dominions and the Colonies, and for provision of rupee credits upto Rs 20 crores

between 1917 and 1919 for the American importers of Indian produce

These exceptional disbursements created a heavy additional demand for currency. In normal years, as we have seen above, the favourable balance of trade was liquidated by free and unfettered imports of precious metals. But during the second part of the War, while the balance of trade increased considerably in favour of India, it became increasingly difficult to meet it, because the import of gold and silver into India, was considerably reduced. On account of the disappearance of a free gold market in London, and on the ground of the conservation of the gold reserves of the Empire in its interests, the export of gold to India was not allowed. The dearth of gold led to a strong demand for silver, the production of which had greatly declined on account of political disturbance in Mexico. Hence, it became progressively difficult to obtain silver and in July 1917 all private import of silver into India was stopped. The total imports of precious metals into India in the quinquennium of the War fell down to £35 984 000, from the prewar quinquennium of £120,242 000. This reduction in the import of the precious metals threw the burden liquidating the favourable trade balance on the Government of India.

Rise in Exchange Causes — This led to an abnormal increase in demand for Councils,

but the Secretary of State was unable to meet the demands of trade, *firstly*, because the sale of Councils cashed in India imposed a heavy strain upon the balances of the Government of India which were being depleted by the enormous expenditure exceeding £250m. on behalf of the Home and Colonial Governments and which it recovered in London. Thus, the strain on the rupee balances in India caused by the War disbursements diminished the Secretary of State's powers of offering Councils at the crucial point. Hence, he limited the sale of Councils which produced an adverse effect on the export trade. *Secondly*, the Secretary of State's financial requirements were covered several times over by the recovery of disbursements in India and therefore, he had no need to sell Councils for his requirements. This led to a *rise in the rupee sterling exchange* and India had to accumulate deferred payments abroad because there was an embargo on the import of gold.

The *second cause of the rise in exchange was the enhancement in the gold price of silver*. The war disbursements in India continuously transferred enormous funds belonging to the Government of India from India to England, and the problem was how to bring them back to replenish the depleted balances. To finance the trade in war materials the Government was obliged to supply a huge quantity of silver rupees, the

absorption of which increased by nearly 250 per cent over the pre-war average, *e.g.*, the absorption of rupees and half-rupees increased from 878 lakhs between 1909-1914 to 2,208 lakhs between 1914-1919. To complete the minimum for safety and to avert the threatend inconvertibility of the note issue the Government was compelled to make large purchases of silver and to coin it into rupees at a time when the production of silver had fallen off on account of the strikes in Mexico and its demand had increased unusually for coinage. The unusually keen demand for silver is evident from the fact that 108m ounces were consumed during 1915-18 in the British Empire alone as against 30.5m ounces between 1910-13. A similar increase in other countries also took place and the more so in China which, instead of being a seller of silver, became an intensive purchaser after 1917. This further increased the additional demand for currency. The Government of India increased her purchases of silver from 180 m ounces to 500 m. oz. These large purchases in the wake of the decline of supply of silver and the increased demand from other quarters led to an abnormal rise in the price of silver. The price at first rose slowly and steadily but afterwards rapidly, specially after the middle of 1919 on account of the depreciation of the dollar-sterling exchange. The price of silver in the London market increased from 27d per stan-

deid ounce in 1915 to 55d in September 1917 when both U. S. A. and U. K. controlled it between September 1917 and May 1919, during which period it moved between 47½d and 50d. The removal of the "pegging" in May 1919 sent the price of silver to 58d which on December 1919 rose to the record figure of 78d per ounce.

The abnormal rise in the price of silver made it impossible to coin rupees at a profit. *e g* in August 1917 the price of silver exceeded 43d which marked the point at which the exchange value of the rupee at 1s 4d was equal to its intrinsic value, so that any rise in the price to 43d and above *made it necessary to raise the exchange value of the rupee.* The rapid rise in the price of silver since May 1919 was due to the exceptional demands from China. Another factor which tended to raise the price of silver in the London market was "*the cross-rate*" *i. e.*, London New York exchange rate between the Dollar and the Pound. As $\frac{3}{4}$ of the world's supply of silver came from America, its price had to be determined by reference to the London New York Exchange, because the Government of India purchased her silver through the Secretary of State in London. Any rise or fall in that rate of exchange reflected itself in the price of silver, because any fall in sterling-exchange would result in paying more sterling for a given quantity of silver than before. Under these circumstances, if silver had to be bought for

Indian coinage, the exchange value of the rupee would have to be raised. Hence, as the price of silver rose steadily, the exchange value of the rupee had to be raised accordingly, otherwise the intrinsic value of the rupees would have been greater than its exchange value, and as a consequence, the rupee would have disappeared from circulation, would have been melted down or exported. This heavy purchase of silver and its rising prices leading to the raising of the exchange rate rendered the prewar currency and exchange system impracticable.

To conclude, as the sterling price of silver rose higher and higher, the bullion value of the rupee exceeded its legal value, making it profitable to melt or export it. This would have happened, if the Government had maintained the legal value of the rupee at its old level of 1s 4d. in spite of the rise in the price of silver. The coining of rupees and the maintenance of the old sterling value of the rupee under such condition would have caused a substantial loss to the Government. Hence, the prohibition of melting rupees was legalised and the exchange value of the rupee at the basis of the councils rates was gradually raised from 1s. 4½d per rupee in August 1917 to 2s 4d per rupee in December 1919 in sympathy with the price of silver. Thus, the Gold Exchange Standard, resting on the fundamental basis of conversion of internal

currency into international currency at a stable rate for remittance purposes, broke down under the stress of war conditions

The following table shows how rates were raised from 1s 4½d to 2s 4d between 1917 and 1919 —

Date	Exchange in Sterling	Date	Exchange in Sterling
3rd Jan 1917	1s 4½d	12th Aug 1919	1s 10d
28th Aug 1917	1s 5d	15th Sep 1919	2s 0d
12th Apr 1918	1s 6d	22nd Nov 1919	2s 2d
13th May 1919	1s 8d	12th Dec 1919	2s 4d

The rise in the exchange rate and uncertainty as to its return to normalcy caused a setback to the export trade, but, on account of certain relieving features, the loss was not immense. These features were:—

- (i) want of competition from foreigners,
- (ii) the heavy demand for India's staple commodities,
- (iii) the actual war rupee prices being higher than the pre-war prices and the exchange difficulties throughout the world

However, after the cessation of hostilities and the gradual establishment of normal conditions, the competition from abroad was revived while the exchange difficulties increased, secondly, the cost of living and expenses of production substantially increased with a rise in general prices, and thirdly, the exchange difficulties of India could not be compared with those of other countries.

Internal

Expansion of internal currency —The huge war expenses necessitated the issue of large amounts of currency. The Secretary of State had no need to sell Councils for his requirements, but, for trade demands he had to sell them in large amounts and the encashment of these drafts in India also necessitated the issue of currency in large amounts. These disbursements were met to some extent out of revenues and the proceeds of the war loans but to a large extent by putting into circulation some gold and large volumes of silver and paper currencies, and by the creation of credit. The result was a *continuous upward movement of prices*. When the rupee balances sank very low, the Government did issue gold coins and bullion but it was of little relief because the Government had no large stocks of gold and the import of it was considered prejudicial to the interests of the Empire. Moreover, the

little issue resorted to was made in a half-hearted and piece meal fashion with the result that *the premium on gold drove gold coins out of circulation*. Then the *issue of notes was resorted to* as far as possible and even beyond the limit of prudence. But their issue was limited by the want of habit among the masses to use notes and especially by the discount and the requirements of keeping an adequate metallic reserve to enable their convertibility on demand. Any effort on the part of the Government to force notes upon the public in large amounts would have shaken the public confidence in Government credit and thus resulted in a serious depreciation of notes and inflation of prices. The Government however, *curtailed the facilities for their encashment* and, on account of the inadequacy of metallic backing, their issue amounted to a compulsion to accept them.

The only course, therefore, left to the Government was to *issue immense quantities of silver rupees*. The absorption of rupees during the war quinquennium increased by 25% as compared with the prewar quinquennium. The Government purchased large quantities of silver for the purpose through the Secretary of State in spite of the difficulties of exchange and the rise in the price of silver. These large imports, however, did not suffice to meet the needs of the Government which passed through a silver crisis in 1918, when its balances sank very

low, and had it not been for the timely help of U S A, which sold large amounts of silver to the Government of India, the inconvertibility of notes could not have been avoided and a serious financial panic would have followed

With regard to the development of paper currency, measures were taken in the beginning to ensure the convertibility of the notes not merely at Currency Offices but also at district treasuries and at the branches of the Presidency Banks. These facilities were made real and effective by suitable arrangement for the supply of the necessary coin. The result was a *phenomenal expansion of paper currency* e g the gross and active circulation of notes between 31st March 1914 and 1919 increased by no less than 132% and 168% respectively. This expansion of paper currency was satisfactory so long as it was voluntary, backed by adequate metallic reserves and freely convertible at its face value. In the absence of any alternative methods to meet the huge war disbursements, the Government began to meet part of the expenses by the issue of paper money. This circulation of the notes was inflated and the note issue ceased to be voluntary. The facilities given in 1915 for encashment of notes in the district treasuries and branches of the Presidency Banks were withdrawn. The rupee balances were concentrated in the head currency offices where the redemption of notes was legalised,

and, to prevent the withdrawal of balances in these offices, *the booking of specie by rail or steamer and its transmission by post was made a legal offence. The notes thus became inconvertible except in the three Presidency Towns.* Later in January 1919, even at the currency offices, the daily issues of rupees to single tenderers of notes were limited to meet only small demands in full. *The result was their depreciation.* Thirdly, *notes of rupee one and Rs 2/8/- were issued in December 1917 and January 1918 respectively against the currency principle that the denomination of notes should not be low.* Moreover, the notes were printed on very bad paper which involved a considerable loss to the cultivators. Fourthly, *the metallic portion of the reserves against the notes continually diminished while the invested portions increased.* At the out-break of the War, the Indian Paper Currency System was based on the principle of the note issue of the Bank of England Charter Act of 1844; the fiduciary portion of the reserve against notes was restricted to 14 crores of rupees and for every note issued beyond this sum a corresponding amount of silver or gold had to be kept in the reserve. During the war, however, the fiduciary portion of the reserve continually increased and the principle of the Bank Charter Act of 1844 was abandoned. This led to the inflation of the paper money and *made it in effect a forced loan from the Indian public, free of interest.*

The fiduciary portion of the reserve amounted to 366% and 647% on 31st March 1918 and 1919 respectively above the pre war average. The metallic portion went on diminishing until on 21st March, 1919 it formed 35% of the total as against the pre-war quinquennium average of 78%.*

Summary of Measures taken by the Government

To meet these abnormal circumstances, the Government first of all tried to control and regulate exchange by putting a limit to the sale of the Councils in London on India, in order to avoid the threatened inconvertibility of the note issue. But this limitation in the Councils, at a time when the demand for remittance to India on account of her enormous favourable balance of trade, was strong, led to a divergence between the market rate of exchange and the rate at which drafts were sold. Therefore in order to allow the continuity of the Indian exports for war purposes unfettered the sale of drafts was confined to banks and firms on the "approved list" which included the chief exchange banks and a few large purchasers, and these in turn were required to do business on prescribed terms with third parties and concentrate their resources to financing the export of commodities needed by the Allies for war only

*For a detailed discussion of the effects of the Great War on Indian Currency and Exchange see Dr Panandikar's "Economic Consequences of the War for India."

Thus, the free and unlimited remittance system had to be suspended and was revived only with the revival of a free gold market and the restoration of normal conditions

Secondly, when the price of silver rose above 43d the rate of exchange was gradually raised in proportion with it from 1s 4d to 2s 4d

Thirdly, when these measures proved ineffectual, the Government increased the supply of currency by purchasing silver through the Secretary of State to the extent of 32 crores ounces in five years. To avoid competition in buying silver, which would have raised its price still further, the import of silver on private account was prohibited in September 1917. Still the world demand for silver being great, the Government of U S A was requested to release a portion of the silver dollars held in their reserves which request was acceded to in April 1918 by the passing of the Pittman Act, which permitted the sale of 35 crores of dollars from the dollar reserve, and out of this the Government of India secured 20 crores of fine ounces and tided over a very serious currency crisis

Fourthly, to protect the currency against dissipation by export or melting the use of silver or gold coin for other than currency purposes was made illegal from 29th June 1917, whereas the export of silver, as we have just seen above, was prohibited except under licence from the 3rd September 1917.

Fifthly, the use of silver was economised by the issue of $2\frac{1}{2}$ rupee and one rupee notes in 1917 and 1918 by the introduction of new two anna, four anna and eight anna nickel coins. Thus, the internal currency was expanded to meet the rising prices.

Sixthly, efforts were made to increase the stock of gold by requiring from 29th June 1917 that all gold imported into India should be sold to the Government. Further, the gold mohur i.e. a fifteen rupee coin of the same weight and fineness as the sovereign was also minted at Bombay to supplement the stock of sovereigns which were issued to the extent of £ 11 m for financing of crops.

Seventhly, as a result of the policy of encouraging the use of notes by providing ample facilities for their encashment the gross circulation of notes increased from 66,12,00,000 to 1,53,46,00,000 by March 1919 and Rs 1,79,67,00,000 by November 1919. But the increased absorption of rupees and the impossibility of purchasing silver, due to its abnormally high price, made the inconvertibility of the notes appear to be inevitable and an unfavourable war news in March and April 1917 caused a run on the Currency Offices. The Government therefore withdrew the facilities for the encashment of notes at the District Treasuries and put restrictions on the transport of specie within the country. It was the delivery of Pittman Silver from U S A that saved

the situation Thus, the gross circulation of notes between 1914 19 increased nearly three fold and necessitated the increase in the *invested portion of the Paper Currency Reserve* which was raised from 14 crores to 120 crores by various ordinances In certain papers of the country there was a discount of 19 p c on the notes but in 1919 it tended to disappear when it was found that notes were freely accepted in payment of Government dues

*Eighthly, various financial measures were also taken to increase Government revenue, and curtail expenditure, various War Loans were floated which yielded Rs 130 crores, and short term Treasury Bills were issued which brought in about 65 crores of rupees All these measures assisted the Government to a very great extent to meet the heavy demand for remittance to India **

*B E Dadachamji *History of Indian Currency and Exchange*

CHAPTER XVII

INDIAN CURRENCY (*Continued*)

Post War Period (1919-25)

We have seen in the last chapter how by various drastic measures and rigid control of exchange the Government was able to tide over the financial and currency difficulties due to the War, but the cumulative effect of all this was to jettison the currency policy pursued so far to stabilize the exchange at 1s 4d gold

Babington Smith Committee and 2s Rupee

On the cessation of the War the highly favourable balance of trade continued unabated on account of the heavy demand from America and England to Manufacture peace time goods and so did the price of silver. Under these circumstances, in May 1919 the Babington Smith Committee was appointed, the chief object of whose recommendations was to secure a stable rate of exchange without impairing the convertibility of the note issue in India and without debasing the standard silver rupee or substituting another coin of inferior metallic content. To attain these ends it was imperative to link the rupee to gold and not to sterling and to fix the exchange ratio at a rate at which silver could be

purchased for coining rupee without loss. *The Committee fixed this rate at 2s gold to the rupee or rupees 10 to the pound, or the rate of one rupee for 1130016 grains of fine gold both for foreign exchange and for internal circulation.* The Committee argued that the rise in exchange (1) had checked and mitigated the rise in Indian prices and had been to the advantage of the country as a whole, (2) that Indian trade was not likely to suffer a permanent injury from the fixing of the exchange at a high level nor would the development of Indian industry be seriously hampered by it, and incidentally it would be of advantage to the Government in meeting the Home Charges *i.e.* (Interest on sterling debts of all kinds, salaries and pensions of civil and military officials, administrative expenses in England, payments for purchase of stores by Governments and railways etc. and freight and commissions etc.) As the rupee falls in its gold value the number of rupees required to satisfy these payment rises. At 1s 4d exchange to remit 25 million pounds in a year the rupee cost would be 37½ crores but at 2s rate it would be only 25 crores, that is to say, a saving of 12½ crores would accrue. On the other hand, a revaluation of the sterling investments and the gold with the Secretary of State would lead to a loss of 38.4 crores which would be wiped out in three years if the saving in Home

Charges were utilised for this purpose only, and thereafter there would be no need for additional taxation. The only Indian member of the Committee Mr. D Dalal, opposed very strongly these views of the Committee and advocated the maintenance of the exchange and its stabilization at 1s 4d. gold and not 2s gold. He very strongly criticized the Government for having bolstered up the exchange during the war by artificial and arbitrary means and warned that the raising of the rate permanently would ultimately bring (1) intense distress to millions of the helpless masses, (2) would disturb the relation between debtors and creditors, (3) would dislocate the export trade, (4) would give a set-back to several Indian industries and (5) would turn the balance of trade against the country.

A perusal of the working of the Indian currency system as it developed after 1893, brings out clearly the inherent weakness of the system in that, while it provided against a fall in the value of the rupee below 1s 4d, it was not a proof against a rise in the value of the rupee above 1s 4d consequent on a rise in the price of silver. *The rupee melting point, in short was not considered in framing the Indian currency policy*

The Government of India accepted the recommendations of the majority of the Committee and notified on 2nd February, 1920, that the acquisition rate for licensed

gold would be fixed at Rs 10 per sovereign; that Council Bills and Telegraphic Transfers would be offered weekly for sale by competitive tenders without any fixed minimum rate, subject to the price of gold being regulated by the Sterling-Dollar Exchange, that the obligation of the Government to give rupee in exchange for sovereigns at Rs 10 was cancelled, that prohibition of, and import duty on, silver were abolished and the prohibition of melting gold and silver coins was removed. The Government announced its intention to maintain the rate at 2s. gold by the sale of Reverse Councils on London at the market rate at a time when the market price of silver was higher than 2s gold. It would be remembered that the report was signed in December 1919, but action was taken on it in the first week of February 1920. This resulted in such an unprecedented demand for the Reverses and speculation that a difference between the Reverse Council rate and the market rate appeared and the money market was completely disorganized. In 1920 the market rate and the rate at which Reverses were sold were in the Period from January to March 1920, 2s. 6d, 2s. 8d, 2s. 10d and 2s. 11d. To add to the difficulties the balance of trade became unfavourable to India. At the time of the notification of the acceptance of the recommendations Indian exchange stood at 2s 4d. (Sterling) and was

weak at that ; the gold rate was 2s. 9d., and therefore to take advantage of this high rate of exchange a great demand for Reverse Councils ensued and the market rate jumped up to 2s.8d. (Sterling). The effect of high exchange rate had been described by the Committee in a pregnant sentence "a high exchange stimulates imports and checks exports, a falling exchange exercises reverse influence. And yet the Government was foolish enough to attempt the stabilization of the rupee at 2s. gold when the export trade was already weak. The effects of the 2s. rupee on Indian currency and trade have been summarised in one sentence by Sir Stanley Reed, "A policy which was adopted to secure fixity of exchange produced the greatest fluctuations in exchanges of any solvent country and widespread disturbance of trade, heavy losses to Government, and brought hundreds of big traders to the verge of bankruptcy."*

"At the moment when it was sought suddenly and violently to raise the rate of exchange by the introduction of the new ratio of 2s. gold, the export trade was weak and the import trade, in obedience to the delivery of long deferred orders, was strong. The very principle enunciated by the Committee wrecked the policy which they recommended. The rising rate

*The Indian Year Book

of exchange scotched the weak export trade and gave a great stimulus to imports. Unexpected forces like the financial crisis in Japan, the lack of buying power on the continent, and the transfer of capital from India to England at the artificially high rate of exchange stimulated these forces, but they had their origin in the attempt by administrative action artificially and violently to raise the rate of exchange. If left alone, the natural fall in exchange would have corrected the unfavourable balance of trade, the official policy exaggerated and intensified it. The effects on Indian business were severe. Exporters found themselves loaded with produce for which there was no foreign demand, importers found themselves loaded with imported goods, bought in the expectation of the continuance of a high rate of exchange, delivered when it had fallen to 1s 4d from the highest point reached. Immense losses were incurred by all importers.* Deflation of currency made the money market tight, and by raising the bank rate of interest on loanable money, and, bringing down the general level of prices, brought the importers into serious difficulties. They were hard hit and were compelled to sell off their stocks at ruinous prices. There was also a disastrous effect on Indian exchange. The Government

**The Indian Year Book*

sold £55,382,000 of Reverse Councils before giving up their attempt to stabilize the rupee at 2s, which meant a loss of 35 crores of rupees to the Indian Exchequer and that too at a time when the trade balance was adverse to India. The Government sold 53 million pounds of gold without seriously affecting the premium on gold and thus depleted the reserves.

Even under these disturbed and unsettled conditions the Government gave effect to the recommendations of the Committee. They made the sovereign and half sovereigns to be legal tender but accepted them at Rs 15 and 7½ respectively if tendered within 21 days of this notification. 2½ m. sovereigns were returned. Both of them were made legal tender in September 1920 at Rs 10 and Rs 5 respectively. They made changes, as recommended by the Committee, in the Paper Currency and its administration.

Having failed to stabilise the rupee at 2s gold the Government tried to stabilise it at 2s sterling. But here again they failed and left the exchange to seek its natural level on 20th sept., 1920. Left alone it settled round about the old ratio of 1s. 4d or Rs 15 to the pound. And the Government then tried to prevent it from falling below this rate by increased taxation and retrenchment, by stopping the sale of Council Bills and by a drastic deflation.

of currency between 1921-22 and later on. As a result of these measures the rupee reached 1s. 4d. sterling in January 1923. The stringency in the money market was met by the issue of 24 crores of emergency paper currency and the exchange began to rise of its own accord; and by October 1924 it rose to 1s. 4d. gold or 1s. 6d. sterling. After this the Government efforts, on the representation from the Bengal Chamber of Commerce, were directed towards a prevention of the ratio from rising above 1s. 6d. sterling. In April 1925 sterling reached gold parity of 1s. 6d. and then the Government action was directed towards preventing a rise of the rupee above 1s. 6d. gold. Since this date the exchange value of the rupee remained practically steady at this figure. In the meantime the Government had appointed yet another Commission known as the Royal Commission on Indian Currency and Exchange presided over by Commander E. Hilton Young.

The issue whether the rate in the next year was held at 1s. 6d. by Government action or by natural forces was the bone of contention between the majority and the minority of this Commission.

Summary of Recommendations

The recommendations of the Smith Committee are summarised below :—

- (1) It is desirable to restore stability

to the rupee and to establish the automatic working of the Indian currency system

- (2) The reduction of the fineness or weight of the rupee, the issue of 2 or 3 rupee coins of lower proportional content than present rupee or the issue of a nickel rupee, are expedients that cannot be recommended.
- (3) The maintenance of the convertibility of the note issue is essential and proposals that do not adequately protect the Indian paper currency from the risk of becoming inconvertible cannot be entertained.
- (4) The rise in exchange, in so far it has checked and mitigated the rise in Indian prices, has been to the advantage of the country as a whole and it is desirable to secure the continuance of this benefit
- (5) Indian trade is not likely to suffer any permanent injury from the fixing of exchange at high level

If, contrary to expectations, a great and rapid fall in world prices were to take place and if the costs of production in India fail to adjust themselves with equal rapidity to the lower level of prices, then it

might be necessary to consider the problem afresh.

- (6) The development of Indian industry would not be seriously hampered by a high rate of exchange.
- (7) The gain to India of a high rate of exchange for meeting the Home Charges is an incidental advantage that must be taken into consideration.
- (8) To postpone fixing a stable rate of exchange would be open to serious criticism and entail prolongation of Government control.
- (9) The balance of advantage is decidedly on the side of fixing the exchange value of the rupee in terms of gold rather than in terms of sterling.
- (10) The stable relation to be established between the Rupee and gold should be at the rate of Rs. 10 to one sovereign, or in other words, at the rate of one rupee for 11.30016 grains of fine gold both for foreign exchange and internal circulation.
- (11) If silver rises for more than a brief period above the parity of 2s. (gold) the situation should be met by all other available means rather than by impairing the

convertibility of note issue. Such measures might be (a) reduction of sale of Council Bills, (b) abstention from purchase of silver, (c) use of gold to meet demands for metallic currency. If it should be absolutely necessary to purchase silver, the Government should be prepared to purchase silver even at a price such that rupees would be coined at a loss.

- (12) Council drafts are primarily sold not for convenience of trade but to provide for the Home Charges in the wider sense of the term. There is no obligation to sell drafts to meet all trade demands, but, if without inconvenience or with advantage the Secretary of State is in a position to sell drafts in excess of his immediate needs, when a trade demand for them exists there is no objection to his doing so, subject to due regard being paid to the principles governing the location of the reserves.

Council Drafts should be sold as now by open tender at competitive rates, a minimum rate being fixed from time to time on the basis of the sterling cost of shipping gold to India. At present this rate will vary but when sterling is again equivalent to gold it will remain uniform.

The Government of India should be authorised to announce, without previous reference to the Secretary of State on each occasion, their readiness to sell weekly a stated amount of Reverse Councils (including telegraphic transfers) during periods of exchange weakness at a price based on the cost of shipping gold from India to the United Kingdom

The import and export of gold to and from India should be free from Government control

- (14) The statutory minimum for the metallic portion of the Paper Currency Reserve should be 40 per cent of the gross circulation

As regards the fiduciary portion of the reserve, the holding of securities issued by the Government of India should be limited to 20 crores. The balance should be held in securities of other Governments comprised within the British Empire and of the amount so held not more than 10 crores should have not more than one year's maturity and all should be redeemable at a fixed date. The balance of the invested portion above these should be held in short dated securities with not more than one year's maturity

issued by the Governments within the British Empire.

The sterling investments and gold in the paper Currency Reserve should be revalued at 2s to the rupee. The depreciation which will result from this revaluation cannot be made good at once but any savings resulting from the rise in exchange will afford a suitable means of discharging this liability in a limited number of years

- (15) With a view to meeting the seasonal demand for additional currency, provision should be made for the issue of notes upto five crores over and above the normal fiduciary issue as loan to the Presidency Banks on the security of export bills of exchange

Minority Report—An important member of the Committee, Mr Dadiba Dalal of Bombay, appended a minority report in which he urged the adoption of the following courses —

- (a) The money standard in India should remain unaltered, that is, the standard of the sovereign and gold mohur with rupees related thereto at the ratio of 15 to 1

- (b) Free and unfettered imports and exports by the public of gold bullion

and gold coins should be allowed.

- (c) Free and unfettered imports and exports by the public of silver bullion and silver coins should be permitted.
- (d) The existing silver rupee of 165 grains of fine silver at present in circulation should continue full legal tender.
- (e) As long as the price of silver in New York is over 92 cents Government should not manufacture silver coins containing 165 grain of fine silver.
- (f) As long as the price of silver is over 92 cents Government should coin 2 rupee silver coins of reduced fineness compared with that of the present silver rupee and same should be unlimited legal tender.
- (g) Government should sell Council Bills on competitive tenders for the amount defined in the Budget as required to be remitted to the Secretary of State. The Budget estimate should show under separate headings the amount of Council Bills drawn for Home Charges, for capital outlay and discharge of Debts. Council Bills should be sold for Government requirements only and not for trade purposes except for purposes men-

tioned in the next succeeding recommendations.

- (h) "Reverse" drafts on London should be sold at 1s. $3\frac{2}{3}$ d. The proceeds of Reverse drafts should be kept apart from all other Government Funds and should not be utilised for any purpose except to meet drafts drawn by Secretary of State at a rate not below 1s. $4\frac{1}{2}$ d. per rupee.
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CHAPTER XVIII

INDIAN CURRENCY (*Continued*)

(A) Hilton Young Commission—1925-26

It was by October 1924 that the rupee reached 1s 4d gold and thereafter the currency policy of the Government of India was characterised by masterly inactivity. The currencies and exchanges throughout the whole world were stabilised by this time but the exchange in India began to rise of its own accord and went upto 1s 6d. when the Government thought it necessary to take stock of the situation and therefore a Royal Commission on Indian Currency and Finance consisting of experts with Commander Hilton Young at its Chairman and Sir Henry Strakosch as Gold expert was appointed in 1925. By this year England had succeeded in stabilising her currency and put it on a firm footing by adopting a Gold Bullion Standard. The Commission had a very wide term of reference which included a detailed and critical examination of the working of the Gold Exchange Standard, the suggestion of a stable standard and of co-ordination of currency and banking system and means to be adopted to achieve it.

The Commission examined a number of

witnesses in Calcutta, Bombay and Delhi and wrote its report in London and submitted it in 1926. It went into a detailed and searching analysis of the Indian Currency and Exchange policy, and examined the various memoranda and schemes for the reorganisation of the currency and exchange system on a sound footing. The main recommendations of the Commissions may be grouped under three heads :—

- (i) a suitable monetary standard for India,
- (ii) the ratio of exchange between the rupee and gold,
- (iii) the creation of a Central Bank of issue with a view to co-ordinate both currency and credit.

(i) As to the suitable standard of currency for India the Commission examined in detail the working of the Gold Exchange Standard which revealed a number of glaring and patent defects and therefore the Commission rejected the restoration and perfection of the G. E. S. on the following grounds.—

- (1) that the system was far from simple,
- (2) that its working was too complicated and intricate to be easily intelligible to the masses in India;
- (3) that it involved arbitrary interference, control, and management

of the currency and the manipulation of exchange by the Government of India. Its management was characterised by a rigidity, inelasticity and a diarchical control of currency and credit. Currency was divorced from credit, the former being controlled by the Government and the later, if controlled at all, by the Imperial Bank of India. The Secretary of State manipulated the exchange according to his requirements and without any due regard to the requirements of the business community in India ,

- (4) that the system was artificial and there was no visible link between the rupee and gold into which it was convertible theoretically ,
- (5) that on account of these causes it had failed to inspire public confidence in the currency and exchange policy of the Government ,
- (6) that it involved an unnecessary duplication of reserve , Gold Standard Reserve and the Paper Currency Reserve for maintaining convertibility of note issue and stability of exchange and for financing the foreign trade of the country through the mechanism of Councils and Reverses ,
- (7) that the system did not secure an

automatic expansion and contraction of currency, and hence, lacked elasticity which is one of the fundamental requisites of a sound monetary policy. The movements of the currency were entirely dependent on the sweet will of the Government of India and Secretary of State and were not dictated by the demands of the business community. During the busy season the currency supply was inadequate which led to an abnormal rise in the rate of discount of the Imperial Bank of India upto 9 and 12%. The provision of the issue of emergency currency to the extent of 12 crores of rupees, on the recommendation of the B Smith Committee, was too inadequate to tide over the seasonal monetary stringency. The system of financing Indian trade was based on cash credit or on the advance of money against a demand promissory note signed at least by two sureties. This caused a shortage of genuine inland trade bills as cover against the seasonal increase of currency. The Government therefore announced in September 1924 to issue currency against treasury bill deposited in the Paper Currency Reserve in London,

- (8) that the internal circulation consisted of rupees and notes with the

unnecessary excrescence of a third full value coin which did not circulate at all *i.e.*, sovereign. The obligation to convert the paper tokens into silver tokens was highly expensive and was liable to vanish if the price of silver went above a certain level (43d. per standard ounce), when it ceased to be a token coin. In other words, the *gold exchange standard was insecure against a rise in the price of silver although it was secure against a fall.*

- (9) that the purpose for which the reserves were maintained was not systematically followed. The chief purpose of the Gold Standard Reserve was to provide for the stability of the rupee-sterling exchange, if the price of silver rose, and with a view to achieve this, the Fowler Committee had recommended that all profits on coinage of rupees should be credited to a special reserve in gold and must not be utilised for any other purpose. But the Government never followed a consistent policy and depleted the reserve by spending it on capital expenditure on the railways or by treating it as a part of the general reserve. The composition of the reserve was similarly unsatisfactory because instead of being kept in gold it was mainly

invested in long term securities of the United Kingdom Government. The recommendation of the Chamberlain Commission to abolish its silver branch was carried out by the Government but its recommendation that a large proportion of it should be held in a liquid form and easily realisable securities could not be given effect to on account of the outbreak of the War. During the War almost the whole of the reserve was held in London in securities in British War Bonds and Treasury Bills and other short term securities. Most of the G. S. R. and P. C. R. was placed in London. The chief argument of this was that it would help to mitigate the exchange weakness caused by an unfavourable balance of trade, but as such a case is an abnormal phenomenon for India it was not necessary to maintain such elaborate standing arrangements to meet what is after all a scarce contingency and the Secretary of State could have easily put himself in funds for meeting his expenses without the reserve being kept in London for the purpose.

- (10) that the system of selling Council drafts by the Secretary of State transferred from India to London from time to time large amounts

and thus it led to the starvation of the Indian money market. The funds thus secured were loaned at low rates of interest to approved borrowers and a good deal of favouritism was shown in the administration of these loans. Then the Council bills were often sold at rates below the specie import point even when there was no necessity for funds in London. Thus, we find that while Indian money was loaned out at very cheap rates in profusion for the benefit of the money market in London, it was locked up in Government Treasuries in India when the Indian money market urgently needed accommodation and the Bank Rate ruled high. The Council Bill system in fact acted as a receptacle to England for as much of India's gold as possible for its own use and diverted the flow of gold from India and saved London the inconvenience and cost of finding it for India. *In fine, the Indian currency system was ill-managed.*

Hence, we conclude that the gold Exchange Standard was a hap-hazard and expensive system, it was never clearly and explicitly defined and many of its practices which had become integral parts of the system had no legal validity. It failed

to destroy the hoarding habit and to teach the people to appreciate the benefits of economical forms of currency. It cared more for stability of the external value of the rupee rather than for the stability of the Indian economic structure and internal prices. *It was a "fair-weather" system and involved too much of executive action and lacked public confidence, stability, certainty and simplicity.* The Commission on these grounds rejected totally the rehabilitation and perfection of the gold Exchange Standard.

Gold Bullion Standard

However the Commission was not in favour of establishing a gold specie standard with gold coins into active circulation. The Geneva monetary principles prevented them from recommending such a course; because, according to the Gold Expert Committee of the League of Nations, the world was suffering from a shortage of gold supply and its mal distribution, and any fresh demand from India for gold for monetary purposes in addition to her normal consumption in industrial arts, would lead to an abnormal rise in the price of gold which would disorganise the currency systems of the world as a whole. Moreover, England had adopted in 1925 a gold bullion standard in which gold was a standard of value but not a medium of exchange, the operation of the system

was automatic in that no restriction was put on the inflow and outflow of gold and gold was available for both external and internal purposes only when there was a tender for a fixed quantity of gold (400 oz. bars). Moreover, the Commission postulated that the circulation of gold would reduce the structure of credit based on the gold in the reserves of the currency authority. "Gold in circulation is of uncertain value for the support of exchange"

In view of these facts the Commission recommended the establishment of a Gold Bullion Standard, with the rupee as unlimited legal tender though a token coin and the withdrawal of sovereigns and half-sovereigns from circulation. The new currency notes were made convertible into gold and the Government had a legal obligation to buy and sell gold in bars of not less than 400 oz. at rates fixed with reference to the fixed gold parity of the rupee. No limitation was to be put on the purposes for which the gold was required. This obligation would secure the stability of the gold value of the rupee and stability of exchange within specie points. As gold bars were to be given for silver or paper tokens not only for export but for any purpose it was an "absolute gold standard". It secured an automatic expansion and contraction of currency. When gold is given by the currency authority in exchange for rupees and notes, the currency

is contracted; and when gold is purchased with rupees and notes the currency is expanded. *"It establishes that gold is the standard of Indian currency at a fixed ratio" although gold does not circulate.* Another recommendation of the Commission was that the two reserves (G. S. R. and P. C. R.) should be amalgamated and the composition and proportions of the combined reserve should be fixed by law to ensure the automatic expansion and contraction of currency; and it laid down that gold securities should form not less than 40% of the total. In order to have a visible link of the currency to gold, and to make it easily intelligible to the masses, the Commission recommended the issue of gold savings certificates redeemable in three or four years and bearing interest. The new notes issued should be made convertible into gold bars; the coinage of the rupee should be stopped to eliminate it gradually in course of years and to reduce it in such a manner as to make it available for small change only. It also recommended the reintroduction of one rupee notes which should not be convertible by law into silver rupees.

How far the gold bullion standard is an improvement on the old standard?

The system secures all the advantages of a pucca gold standard and at the same time it has the advantage of the gold exchange standard in economising the use of gold, by making gold as a

measure of value without its being a medium of exchange. The market for gold is free and the government is under an obligation to buy and sell gold at a fixed price (1s 6d to the rupee or Rs 41-3-10 per tola). Gold is obtainable for any purpose. Unlike the gold exchange standard no restriction is put as to the object for which gold can be obtained from the currency authority. The system has removed all the defects of the gold exchange standard which we have already discussed in detail and need not repeat. The link of the currency to gold is visible, the operation of the system is simple, it is stable and inspires public confidence, it is certain and elastic. It is free from excessive government interference, and control and secures an automatic expansion and contraction of currency. The cumbersome and expensive duplication of reserves has been removed and now the reserve can be utilised more effectively and conveniently to tide over a financial stringency. The divided control between currency and credit and the consequent lack of co-ordination has been removed by the establishment of a central bank with a monopoly of supply of currency and effective control of credit. It has the advantage of establishing an immediate gold standard without causing disturbance to the world gold and silver markets and without upsetting the prices, trade and industry in India. It discourages the hoarding of precious metals and by inspiring confidence develops the habit of banking and investment.

(ii) As regards the establishment of a central bank to co-ordinate currency and credit, the commission recommended the creation of a Reserve Bank of India and laid down the conditions under which it should function as a bankers' bank and a government bank, defined its functions and suggested a scheme for its organisation and control. We shall deal with these in the chapter on the Reserve Bank of India in the Second Part of the Book.

(iii) With regard to the ratio of exchange the majority of the Commission recommended a ratio of 1s. 6d. while the minority consisting of Sir P. Thakurdas recommended 1s. 4d. A battle royal has been waged round this ratio controversy between the non-officials and the government. We shall summarise the argument for and against both the ratio.

Arguments for 1s. 6d.

(i) *Adjustment of Indian to World prices:*—The Majority recommended the rate of exchange to be 1s. 6d. gold for the rupee at which rate they contended that prices in India had already attained a substantial measure of adjustment with the world prices and any change in this *de facto* rate would lead to a widespread economic disturbance and a difficult period of re-adjustment. It would cause widespread disturbance to Indian commerce and trade. The

reversion to 1s 4d would lead to 12½% rise in prices which would be very hard on the people with fixed incomes and on consumers.

(ii) *Adjustment of Wages* —They further argued that wages in agriculture and industry had adjusted with the present level of prices and exchange and any reduction in the rate would lead to a reduction in wages on account of increased prices. It was undesirable.

(iii) *Effects on contracts* —Admitting that the burden of the land revenue had increased on account of the new ratio because the rates were fixed when the ratio of exchange was 1s 4d, they thought that the loss involved to the cultivators in stabilising the ratio at 1s 6d had been made up by the rise in prices during and after the War. The real burden of land revenue measured in terms of commodities had been very materially lightened and therefore the ratio of 1s 6d would not inflict a hardship in this respect. With regard to short term contracts, they were entered into when the rate of exchange was about 1s 6d or it was in a state of flux, and that, after the prolonged disturbance caused by the war it was not possible to do justice to debtor or creditor by fixing any particular rate of exchange. Hence on account of adjustment of prices and wages to the new level of exchange, the least disturbance would be caused by adherence to the *de facto* ratio.

(iv) They did not accept the contention of the minority that the rate of 1s 6d was a result of the government manipulation of currency and that 1s 4d was the *de jure* or *legal ratio*. If the fact of adjustment was there, it was immaterial how the adjustment had been achieved. With regard to the statement that the new ratio would accentuate the fall in prices in India when gold prices would fall they said that it was unlikely, and, that if there was a trade depression in the world India would suffer whether the rate was one or the other. They further stated that a sudden fall in exchange would cause a boom followed by a slump which would dislocate the foreign trade. It would affect adversely the budget by causing a loss of Rs 6 crores per annum, would cause increase in taxes, railway rates and fares, and disturb the trade and commerce of the country.

Arguments for 1s 4d

The real bone of contention between the majority and the minority was whether prices and wages had adjusted to the new ratio and whether the new ratio was a result of natural forces or was bolstered up by government action. It was argued that 1s 4d was the *natural or legal ratio* and that the rupee was maintained at 1s 4d by official administration of the currency through deflation and artificial

maintenance of the fictitious 2s gold ratio, that 1s 6d was not *de facto ratio* and prices and wages had not completely adjusted to it. It would put a premium of 12½% on foreign imports into India at the cost of Indian manufacturers and producers. With regard to the effect on government finances, the loss occasioned to the government on the payment of the Home Charges would be more than counter-balanced by the increased revenue from customs duties and income tax upon the increased profits of industry if the ratio was 1s 4d. Moreover, the gain to the government in the payment of Home Charges will be contributed by the producer. Larger resources would be required to maintain the higher ratio. The agriculturists who constitute 79% of the population and are heavily indebted would particularly suffer a loss of 12½% in their prices, and in payment of land revenue and interest etc. Finally, the rise in prices due to 1s 4d. would not hit the wage earners as the wages were sufficiently high, and the possibility of continued employment, which the greater prosperity of agriculture and industry under the lower ratio would ensure, would be a further advantage. It was held by Sir P. Thakurdass that the wages had not adjusted to the new ratio and any forced adjustment would cause a bitter struggle between capital and labour to the detriment of both. No other country had adopted a higher rate than its pre-war

ratio and as 1s. 4d ratio remained effective for nearly 25 years (1893 1918 August) it was the *de facto* ratio and should not be changed.

Conclusion — An examination of the arguments in favour and against the 1s 6d. and 1s 4d ratios shows clearly that the arguments of both sides were not flawless. The government declared their intentions to stabilise the rupee at the new ratio but the controversy kept smouldering and during the period of the great depression it became very acute. On account of unforeseen and unprecedented conditions the Government resorted to currency contraction, issue of Treasury Bills, raising the Imperial Bank Rate etc to maintain the exchange stable at 1s. 6d This manipulation and interference was cited by the critics as proofs of the unwisdom in fixing the ratio at 1s 6d The difficulty of the government in securing necessary sterling funds for remittance to London led to the transference of balances from the Paper Currency Reserve to the Secretary of State in London, to the heavy sterling borrowings in London and to the contraction of rupees in India Between November, 1930 and March 1931 when sterling could not be purchased they sold sterling and later on Reverse Councils to support the rupee The disturbances of the world crisis and fall in prices, the uncertainty of the political situation in the country, and specula-

tion in exchange were other factors which weakened exchange. These government measures to meet the situation were also cited as proofs of the unsuitability of the new ratio. Thirdly, the downfall in the quantities of the principal exports due to an abnormally high fall in prices and the depression in industries were all supposed to be the outcome of this new ratio. As a matter of fact they were due to the world slump and the New York financial crisis culminating in the downfall of the gold standard and it is not right to blame the rate of exchange for all this.

Government Action — The recommendations of the Commission were accepted by the Government and on January 16, 1927, they issued three bills embodying them. Of these, the bill relating to the establishment of Reserve Bank was thrown out by the Assembly but that embodying the Gold Bullion Standard was accepted. Accordingly the Currency Act of 1927 was enacted and came into force on 1st April, 1927. *The rate of exchange was fixed at 1s 6d gold i.e. the rupee was made equal to 8.47512 grains of fine gold and a legal obligation was imposed on the Government to buy gold in unlimited quantities at the Bombay Mint at the price of Rs. 213.10 per tola of fine gold in bars of not less than 40 tolas, and to sell for legal tender currency either gold at the Bombay Mint or sterling for delivery in London, at the option of the Government, at the rate of*

Rs 21 3 10 per tola of fine gold in amounts of not less than 400 oz bars or 1065 tolas Sterling was to be sold at 1s 5 $\frac{1}{2}$ d to the rupee

(B) 1927—1931 and After

1927-1931 :—According to the Act of 1927, the standard of currency in India was Gold Bullion-cum-Sterling Exchange Standard, because Government had the option to supply gold or sterling. Gold was to be supplied at the rate of Rs 21 3-10 per tola of fine gold in quantities of not less than 400 oz Sterling was also to be supplied at the rate of 1s 5 $\frac{1}{2}$ d Sovereigns and half-sovereigns were deprived of their legal tender quality but the Government undertook to receive them at all currency offices and treasuries at the rate of Rs 21-3-0 per tola of fine gold or Rs 13-5-4 per sovereign The Government was prepared to buy gold in unlimited quantities at the same rate provided it was offered in bars of not less than 40 tolas or 15 oz This system worked smoothly upto 20th September 1931 and was just like the gold exchange standard because sterling was at par with gold Since the Act of 1927, imposed an obligation on the Government to buy gold and sell gold sterling at fixed rates, it is called the gold bullion cum-sterling-exchange-standard

England went off the gold standard on the 21st of September, 1931 and an ordi-

nance was promulgated on the same date in India prohibiting the sale of gold and sterling by the government at the statutory rate of 1s 6d. The Indian public thought that the government would maintain the ratio of 1s. 6d. and that the rupee would be left free to seek its own level. The Government of India, however, had not received any definite instructions from the Secretary of State and, therefore a bank holiday for three days was declared. On September 24, another ordinance was promulgated to declare the intention of the government to maintain the ratio of 1s 6d and in order to avoid speculative dealings in exchange and to prevent the import of bullion on private accounts, it was announced that sterling would be sold only to the recognised banks for financing normal trade requirements and contracts completed before September 21, 1931. The chief object of this ordinance was to avoid a strain on the gold and the sterling resources of the Government of India and to prevent the export of capital abroad. The control was to be exercised through the Imperial Bank. However, as sterling depreciated in terms of gold, the rupee also depreciated similarly, and there was a rise in the price of gold. This unexpected rise in the price of gold led to the export of gold in huge quantities, and therefore, the restrictions on the sale of sterling became unnecessary. Hence, the Ordinance of 1931

restricting the sale of sterling was withdrawn in 1932, but the rupee remained linked with sterling. *From September 1931 therefore India has a Sterling Exchange Standard.* The essentials of this system are fundamentally the same except that the provision regarding the convertibility of notes into gold bullion which existed prior to it no longer holds good, the government is under no obligation to buy and sell gold in quantities of 400 ounces bars either for internal or for external purposes; but they buy and sell sterling at the same statutory rates viz. 1s. 6 $\frac{1}{2}$ d. and 1s 5 $\frac{1}{2}$ d.

Criticism: The currency policy of the Government since 1931 has been vehemently criticised on two main grounds.

- (i) *the linking of the rupee to sterling.*
- (ii) *the unrestricted export of gold.* Since the Government went off the gold standard Rs. 382,52,38,069 worth of gold has been exported upto 1939-40.* The main arguments against the linking of the rupee to sterling are as follows:—

1. The rupee has been fastened to the chariot wheel of sterling and has to dance according to the tunes called by it. It was being made to follow

*Reserve Bank's Report on Currency and Finance 1940-41.

the fluctuations of sterling which reflected the economic conditions of England and not of India. If the rupee were left free to seek its own level it would reflect the economic conditions in India and would be regulated in the interests of the foreign trade and internal prices of the country. It has made the Indian prices dependent on English prices and thus caused instability.

2. The linking of the rupee to sterling has given a preference to English goods imported into India at the expense of the gold standard countries* with which the exports of India were greater. It has introduced imperial preference through the back door.

There was a danger of dissipation of the gold reserves of the country, but this has been prevented by the sale of sterling

4. Although the rupee has depreciated in gold it remains over-valued in terms of sterling though other coun-

*With a rupee equal to 1s 6d sterling which bought less American or French gold currency than before it became less profitable for Indian importer to import goods from America or France which were still on the gold standard than for instance from England which had departed from it' Dr L C Jain
The Indian Monetary Problems p 45

tries have devalued their currencies in sterling Depreciation of the rupee in sterling is necessary in order to put the foreign trade of India on a sound basis.

- 5 That it was definitely against the recommendations of the Hilton Young Commission which was against the linking of the rupee to the currency system of a single country howsoever stable it may be.
6. It has caused an unusual export of gold from the country

Arguments in favour of the linking of rupee- to sterling

1 The choice before the government was between comparative stability of rupee exchange and leaving the rupee to drift. The stability of exchange would facilitate foreign trade whereas the instability, which would arise from leaving the rupee to follow its own course, would hamper foreign trade.

2 A large amount of sterling debt (£15 m.) was maturing and it would be difficult to raise a loan in London at a fluctuating rate of exchange to meet it.

3 India's trade with the sterling block was considerable and the stability of exchange with that block would be a great advantage. India's exports to gold standard

countries would be stimulated as the rupee would depreciate in value.

4 The rupee at 1s 6d sterling was worth less than 1s 4d. gold and those therefore, who wanted to stabilise the rupee should not criticise the government linking it to sterling. It has strengthened reserves by causing an increase of 5 crores in their rupee value.

5 It has enabled India to purchase more of foreign goods and by increasing the purchasing power of her customers has encouraged the flow of trade. All these arguments advanced by the government spokesmen conveniently ignored that the Indian business community demands a devaluation in sterling to prevent an increase in imports from Britain.

The export of gold from the country has been criticised on account of a depletion in, and wastage of, the gold resources. The H. Y. Commission had recommended that no favourable opportunity should be lost by the Government for strengthening the gold resources but when other countries were putting restrictions on gold exports, India was allowing her gold to be drained away. This would make it impossible to adopt a gold currency at any time. It is further alleged that it is "distress" gold and not commercial gold which is being exported and therefore the huge profit on export of gold does not prove that ,

is surplus gold that is being exported. But the Government argues that it cannot purchase gold at such high prices from the public, that with a fall in the price of gold, it will again come into the country, that in the meantime it has facilitated imports and produced a welcome influence on the finance of the Government, and has improved India's credit in London and abroad by keeping the rupee sterling exchange stable at 1s 6d. That the credit of the country has improved is proved by a substantial fall in the interest rates on Government securities or loans and by a reduction in the floating debt by the creation of fresh currency. It has benefitted the farmers and enabled them to live on their past savings in a period of acute depression and falling prices.

Even France, the leader of the gold block, has devalued the franc a number of times to conserve her gold resources but India is frittering away her resources. True it is that the Government of India have been able to produce surplus budgets and have saved a good deal on interest payments by conversion of loans but all this has been possible by the regular stream of gold export and as the gold resources of the country are not inexhaustible it is difficult to see how the stability of exchange can be maintained in future without a devaluation of the rupee. The interests of Indian industrialists and businessmen are

being sacrificed at the altar of stability of exchange and the balancing of the Government budget

When the Reserve Bank of India was established the problem of the standard of value for India became very acute. What the Government has practised since September 1931 was regularised and made statutory by the R B Act 1934. The London Committee on the Reserve Bank Bill in its report of 1933 stated that in the existing state of monetary disorganisation in the world it was not possible to stabilise the rupee at a point which would prove stable in future as well. Till then therefore, India was to have the sterling exchange standard in which the mere operation of Reserve Bank Act should not bring any change. The majority of the Indian delegates, however, thought that the question of a suitable exchange ratio was an essential factor for the successful working of the Reserve Bank and Sir P. Thakurdass made a very eloquent appeal in the minute of dissent for devaluation of the rupee in order to raise prices, and to stabilize trade. He quoted the example of U S A, Australia and Newzealand etc. But the Government persisted in sticking to 1s. 6d sterling and in 1934 when the Reserve Bank Act was passed, the same ratio was adopted. According to sections 40 and 41 of the Act the Reserve Bank was required to sell sterling at 1s. $5\frac{1}{4}$ d per rupee at its offices

in Bombay, Calcutta, Delhi, Madras and Rangoon, provided the tender is for not less than £10,000. Similarly the Bank was to be under an obligation to buy sterling for immediate delivery in London at 1s 6 $\frac{3}{8}$ d to the rupee. In other words, the Bank was charged with the maintenance of the value of the rupee between these two limits just as the Government before the War prevented the rupee from falling below 1s 3 $\frac{3}{8}$ d and from rising above 1s 4 $\frac{1}{8}$ d. Thus we have at present *Sterling Exchange Standard in India with this improvement on the Gold Exchange Standard that the two separate currency reserves i.e. the Paper Currency Reserve and Gold Standard Reserve have been amalgamated and both currency and credit are now controlled by the Reserve Bank.* However, the problem of the standard of value still remains unsolved and clause 55 of the Act requires the Bank to report to the Government, with regard to the measures for the future monetary standard for India. But there is no likelihood of India adopting a permanent monetary standard until the international monetary situation improves.

Delinking of the Rupee from gold and its effects —It was in 1927 that the Government of India on the recommendations of the Hilton Young Commission adopted Gold Bullion Standard and linked the rupee to gold at 1s 6d (Re 1=847 grains of gold). This continued till 21st Sept 1931 when England went off the gold standard and

after a bank holiday for three days the Government of India was compelled to delink the rupee from gold and relink it with sterling at the same ratio. This delinking of the rupee from gold therefore was done by the government not voluntarily and not according to the requirements of Indian trade, commerce and industry. This had very important repercussions on the course of India's trade.

The most fundamental defect of the linking of the rupee to sterling was the fact that the rupee had to move in accordance with the movement of the rupee sterling ratio, the fluctuations in which reflected changes in the English economic conditions rather than in the Indian economic conditions. The rupee in other words was compelled to play a second fiddle to the pound sterling, and was no longer an independent unit of value. The sterling value would rise and fall according to inflation or deflation in England, and because the rupee was linked to sterling the rupee sterling ratio would rise or fall simultaneously in sympathy with the pound sterling.

The most disadvantageous effect of the delinking of the rupee and its linking with the pound sterling has been the flight of enormous quantity of gold from the country to England and other countries. More than 382 crores worth of gold has been

exported from the country up to 1939—40. This has been the most unexpected and unprecedented event in the history of Indian currency and exchange. Prior to this our country had been absorbing a large quantity of the precious metals* on account of her favourable balance of trade except for a few years in the period of the war and the post-war depression. In fact the imports of precious metal had alarmed the European countries and America and they had looked upon our country as a sink for the precious metals, and it had been one of their stock arguments in opposing the adoption of a gold standard with a gold currency by us. Ever since 1927 upto Sept 1931 India had been exporting and trying to dispose of her surplus silver in order to replace it by gold to strengthen the gold reserve and satisfy the national sentiment of having a gold currency. But all this was given a sudden shock by the delinking of the rupee. This enormous exodus of gold from the country has alarmed the nationalists who have tried now and again to bring pressure on the government to stabilise the rupee at 1s 4d gold and make it an independent unit of value but to no purpose. Mr Manu Subedar, the President of the Indian Bureau and Cha-

*Between 1900 01 to 1930 31 we imported gold worth Rs 714 50 9 369 and exported gold worth Rs. 166,75 47 540 i.e. there was a net import of gold worth Rs. 547,75,47 829 Reserve Bank Report 1940—41.

mber of Commerce, Bombay, while welcoming the Finance Member, in 1935 appealed to him for saving the country and specially Indian industry and trade from the blighting effects of the appreciation of the rupee in terms of sterling, but the Finance Member gave a very curt reply that he would be no party to 'monkeying with the ratio'. It is alleged that it is distress gold which India is exporting and therefore it amounts to an export of capital which accentuates the already existing paucity of funds in the Indian money market. On the other hand it is pointed out by the Government that the ryot is taking advantage of the high price of gold and is replacing it by increased supply of money. The export of gold has helped India in the period of the depression to maintain her exchange stable, to keep up her balance of trade, and has saved the government finances from budgetary deficits and increased taxes. Money is very cheap today and the government has taken advantage of it in the reduction of interest rates on loans by a judicious policy of conversion. However, this export of gold from the country in alarming quantities has minimised the chances of an early restoration of the gold bullion standard, and the introduction of a full fledged gold standard has been postponed to an unknown remote future. The Nationalists further smack a deliberate attempt on the part of His Majesty'

Government to tie the rupee to the chariot wheel of sterling in order that the trade relations between India and England may not turn out to be unfavourable to the latter. It is a fact that British industry and trade were suffering very heavily on account of the maintenance of the gold standard ever since the slump of 1929 and the heaviest hit of all these was the English export trade comprising cotton, iron and coal industries. In India English industry and export in Cotton textiles was losing ground rapidly to the Japanese and this tendency has been arrested since the linking of the rupee to sterling. To some extent therefore it has helped the British goods in the Indian market against foreign and internal competition. There had been a substantial fall in our exports of merchandise before the present war and gold exports from our country "have enabled the United Kingdom to pay part of her debts to France and United States *.

It is surprising that even in the last two years when the favourable balance of trade in merchandise between 1939-40 and 1940-41 has been Rs 91.11† crores there has been an export of gold worth Rs 44.65 crores in 1939-40 only and perhaps more so in 1940-41 including purchases by the

* Brij Narain ' *India in the Crisis* ' p 107

† Reserve Bank Reports 1939-40 and 1940-41
(48-90) (42-41)

Reserve Bank for foreign buyers This is explained by payments in sterling This loss of gold in abnormal times of war is extremely unfortunate and alarming and should be stopped by an embargo on export of gold and its purchase by Reserve Bank for foreigners The American balances in dollars should be used for purchase of gold there and the Reserve Bank should also buy gold both here and in America to strengthen its reserves and should revalue its existing stock of gold at present rates

CHAPTER XIX

INDIAN PAPER CURRENCY

1823 to the Present Day

Before 1862, the Presidency Banks of Bengal, Bombay and Madras had been given by their Charters the right to issue notes together with some other banks because it was thought at that time that the issue of notes was the proper business of banks. The maximum amount of notes that could be issued by the Bank of Bengal was limited to Rs 2 crores and the limit in case of the other two taken together was Rs 3 crores. A specie reserve of $33\frac{1}{2}\%$ had to be maintained by them and this was reduced later on to 25%. These notes however, on account of the unfamiliarity of the people with paper money and the lack of adequate means of communication did not enjoy universal acceptance throughout India, but were in current use only within their circles of issue in the towns of Bombay, Calcutta and Madras. Even their denominations were not uniform. Mr James Wilson, the first Finance Member of the Government of India, worked out a scheme on the Banking principle of note issue in 1859 to deprive the Presidency Banks of their right of note-issue, but before action

could be taken on it he died. Then his successor Mr. Samuel Laing was influenced by the Currency principle of note issue, aiming at security rather than elasticity and his views were upheld and confirmed by the Secretary of State, and *the Paper Currency Act of 1861 was passed and note issue became a State monopoly of the Government of India.* The scheme of the government note-issue was modelled on the Bank of England Charter Act of 1844.

The salient features of the Act of 1861 were —

- (a) the abolition of the right of note-issue enjoyed by the Presidency Banks and the issue of government paper currency through a Paper Currency Department,
- (b) the lowest denomination was to be Rs 10,
- (c) the division of the country into 3 circles of issue (in the beginning) with each Presidency town as the centre of the circle
- (d) notes to be legal tender in their circles for all payments, except by government, at offices and agencies of issue
- (e) a reserve of coin or bullion to be kept against the notes issued except an amount not exceeding Rs 4 crores which was to be invested in government securities, and
- (f) notes to be issued to the public in unlimited amounts against rupees and against gold sovereigns and also in exchange for

foreign gold coin or bullion on the requisition of the Controller of Currency, and these features continued unchanged upto 1914. Thus, the Fixed Fiduciary system of note issue was followed based on absolute security and at the expense of elasticity, which was badly required in the Indian currency and banking system on account of the heavy demand for money during the busy season and the lack of adequate banking facilities in the land. It was moreover an expensive system because its rigidity necessitated the maintenance of large reserves in coins and bullion practically equivalent to the quantity of notes issued. The denominations were Rs. 10, 20, 50, 100, 500, 1000 and 10,000.

With the growing familiarity of the people with the use of notes, confidence in their convertibility and the spread of education, *the rigidity and inelasticity of the system relaxed after 1890, and the circulation increased rapidly thereafter. The suspension of free coinage of silver in 1893 and the increase in the fiduciary portion were responsible for it. Moreover, certain changes introduced in the working of the system operated in the same direction. A note of smaller denomination (Rs. 5) was introduced in 1891 to facilitate small payments. Then, the restrictions on circulation and legal tender were modified. Though the notes were convertible originally at the*

head office of the issue circle, yet for the facilities of travellers and railway companies they were encashed at government treasuries and government dues could be paid in notes of any circle. The circle system was preventing the expansion and popularity of the notes. To increase their circulation it was imperative to universalise them. Therefore in 1903 the five rupee note was made universal legal tender except in Burma but this restriction was also removed in 1909. Then the 10 and 50 rupee notes were made universal in 1910 and those of Rs 100 in 1911. The Chamberlain Commission in 1913 recommended the universalisation of the Rs 500 notes but it was only in 1931-32 that Rs 500 and Rs 1,000 notes were made universal legal tender. The increased circulation led to a quick expansion of the note-issue.

Further facilities for encashment were later on provided at government treasuries and also by the Presidency Banks. The number of circles also increased later on and in 1910 there were seven of them viz., Calcutta, Bombay Madras, Rangoon, Karachi, Cawnpore and Lahore.

*Paper Currency Reserve —*Changes were also made in the Paper Currency Reserve. The invested or fiduciary portion was fixed in 1861 at Rs 4 crores, but it was gradually raised to Rs. 6 crores in 1871, 7 in 1891, 8 in 1892, 10 in 1897 and 12 in 1905. All these

were held in rupee securities but in 1905 Rs 2 crores were invested in sterling securities in England and another Rs 2 crores were added to it in 1911 when the total Fiduciary Reserve stood at Rs 14 crores. Since 1905 therefore a part of the invested portion of the reserve had been kept in sterling securities. Upto 1893, the whole of the metallic reserve was held in silver coins in India but the Act of 1893 authorised the issue of notes against gold coin or bullion to any amount. The Gold Notes Act of 1898 authorised the issue of notes against gold deposited in London with the Secretary of State as a temporary measure to relieve monetary stringency in the money market, but in 1902 it was made permanent and thus a portion of the P C R was kept in London in gold to buy silver for coining rupees in India. Then in 1905 an other Act authorised the holding of the metallic reserve or any portion thereof either in England or in India and in silver coin or bullion, and gold coin or bullion. All the rupee coins were to be held in India only. As a result of these measures the Secretary of State was enabled to sell Council Bills to an unlimited extent for gold deposited in London against the issue of notes to an equal amount in India and, the transferred portion of the P. C R. in London in gold in this way was utilised for the sale of Reverse Councils by the Government of India to support the exchange. Thus the branch of the P C R in London served two objects purchase

of silver by the Secretary of State for coining rupee in India and the maintenance of the exchange value of the rupee. Gold worth £5 m was diverted to London from India in 1905 to buy silver. With the expansion of note circulation an ever declining proportion of the Reserve on account of the Fixed Fiduciary principle was invested and a growing proportion (80 to 85%) was kept in a fluid form to maintain the external value of the rupee in times of emergency. On 1st March 1913, the composition of the Reserve stood as below

In Crores of Rupees

Total circu- lation	Silver in India	Gold in India	Gold in England	Securities in India	Securi- ties in England
68.98	16.45	29.38	9.15	10	4

It is clear from this that the invested portion of the Reserve in securities was a little over 20% of the total and this was a much lower percentage than the usual in the previous years. This brings out clearly the rigidity and inelasticity of the system and its expensiveness. In other words *it lacked both economy and elasticity*, which are the inherent defects of the Fixed

Fiduciary method of note issue and which, unlike England, could not be removed by the development of cheques and deposits here on account of the backwardness of banking and illiteracy of the masses. The investment of a part of the Reserve in sterling securities in England has also been criticised.

Chamberlain Commission —Such was the position of the Paper Currency upto the appointment of the Chamberlain Commission. The Commission emphasised the need for increased elasticity of currency to meet the requirements of ever-expanding trade and commerce of the country and pointed out how the Fixed Fiduciary system, which could be changed only by a special act, had made it inconvenient to achieve elasticity. The securing of a little of elasticity by the Gold Note Act of 1893 and the sale of Councils was not desirable. The majority however justified the increase in the gold and sterling reserve in London for the maintenance of the stability of exchange. To secure greater elasticity the majority recommended that the fiduciary portion should be increased from Rs 14 crores to Rs. 20 crores, and thereafter should be fixed at a maximum of the amount of notes held by the Government in the Reserve Treasuries plus $\frac{1}{3}$ of the net circulation (*gross circulation minus the amount held in Reserve Treasuries*). The Government should take power to make temporary

investments or loans from the fiduciary portion within this maximum in India and in London, as an alternative to investment in permanent securities. In India such loans should be made to the Presidency Banks on prescribed terms, and in London, the Secretary of State should have the power to lend out sums received in payment of Councils sold against the Currency Reserve in the busy season, provided that the total cash portion of the Paper Currency Reserve does not fall below $\frac{2}{3}$ of the net circulation. The Rs. 500 note should be immediately universalised and more facilities should be given for encashment and the use of notes should be encouraged by all legitimate means. The Commission thought that these measures would permanently increase the invested portion without endangering the complete convertibility of the notes, the government revenues would increase by interest on the investment of gold lying idle in India, they would increase temporarily the quantity of money in circulation to ease the stringency during the busy season, would facilitate the sale of Councils by the Secretary of State and would enable an increase in permanent or temporary investments of the Reserve without special acts of the Legislature and would make the Paper Currency elastic. However, these recommendations could not be given effect to because the War broke out while the Government was considering

them But facilities for encashment were given soon after the out-break of the War

War and its Effects — When the War broke out there was a great run on the Currency Offices by Indian business community for the conversion of notes and during the first 8 months of the War 10 crores of rupees had to be paid Gradually confidence was restored and from 1915 onwards the note circulation increased rapidly A great demand for money was created by the fact that in addition to normal requirements of trade and industry, the government was making heavy purchases of Indian primary products on behalf of the Allies and as silver could not be obtained to coin rupees to meet this increased demand, the government had to resort to the inflation of paper currency *The fiduciary portion of the Reserve on account of this difficulty of obtaining silver had to be increased by special Acts and ordinances from Rs 14 crores in 1914 to Rs 120 crores in 1919 and the permanent and temporary investments increased from 14 crores to 20 crores and from 6 crores to 100 crores respectively* By the Act of 1919 the invested portion was fixed at Rs 120 crores of which Rs 100 crores could be invested in British Treasury Bills (introduced in 1916) During the same period the gross circulation increased about three fold while the metallic reserve fell from 78.9% in 1914 to 35.8% in 1919 (nearly 50%) On the other hand, the percentage of securities to gross note circu-

lation increased from 12 to nearly 54. The *extra facilities for encashment of notes were abolished* on account of scarcity of rupees and hence they were at a discount in many places (in some places it was 19%). To increase the note circulation *notes of Re. 1 and Rs. 2½ were issued in December 1917 and January 1918 respectively. Moreover, two hundred million ounces of silver were also purchased from America in April 1918 to meet the increased demand for money.*

*Babington Smith Committee:—*This Committee made various proposals for the greater elasticity of note issue and for its stability. The main recommendations were:—The fiduciary portion should not exceed 60% of the gross circulation and the gold in the Reserve should be revalued at Rs. 10/- to a sovereign; that the permissive fiduciary maximum of Rs. 120 crores should be retained for some time more and of these not more than Rs. 20 crores should be in the securities of the Government of India; that to meet the seasonal demand for additional currency Rs. 5 crores of notes over and above the normal fiduciary issue should be issued as loans to the Presidency Banks on the security of export bills of 90 days' maturity, that the metallic portion of the reserve should be held in India except for buying silver in London; and that the facilities for encashment of notes should be increased and the war time restrictions removed and the government should have

the option to redeem its notes in full legal tender gold or silver coins.

1919-26.—These recommendations of the Committee went rather far to improve the elasticity of notes and keeping in view the popularity of silver rupees and the illiteracy of the masses the metallic reserve was too low at 40% and the fiduciary portion was rather high at 60%. By amending the Act in 1919 the maximum limit of the investment reserve was fixed at Rs. 120 crores out of which Rs. 100 crores were to be invested in the British Treasury Bills. The increased demands for remittances to London were leading to sale of sterling securities and this would have caused a cancellation of notes to the full value of the securities sold at the rate of Rs. 15 to £ 1. To prevent this in March, 1920 the retention of the invested portion at Rs. 120 crores was extended for six months and the restrictions to the locations of the investments and their sterling or rupee character were abolished. In October of that year these temporary measures were replaced by an amended Paper Currency Act of 1920 which was based on the recommendations of the Committee and provided for the issue of notes against sovereigns and half sovereigns at the new rate of Rs. 10 per sovereign and against gold bullion at a rate of Re. 1 = 1130016 grains of fine gold. Its further provisions were classified into Permanent and Temporary. The first of these were

meant for the automatic elasticity and the second of them were to meet the difficulty of revaluing the securities at Rs 10 instead of Rs 15 to the sovereign. The *Permanent Provisions* were —

- (a) That the metallic reserve should be 50% of the total notes in circulation *i.e.*, the invested portion of the Reserve should not be more in value than the metallic reserve and that the gold held by the Secretary of State shall not exceed Rs 5 crores or £ 5 m. The higher percentage, as compared with the Committee's recommendation, was due to the necessity of encashing notes on demand and to finance the movement of crops during the busy seasons.
- (b) That excepting Rs. 20 crores of securities held in India, the balance was to be held in England in short term securities of not more than 12 months' duration and of Rs. 20 crores, not more than 12 crores were to be held in the "*created or ad hoc securities*" of the Government of India.
- (c) That emergency currency was to be issued in the form of loans from the Reserve to the Imperial Bank of India at the rate of 8% to the extent of Rs 5 crores against 90 days' accepted bills of exchange. This

limit was raised to Rs 12 crores in 1943. This extra issue was not to be considered for determining the 50% metallic reserve

These permanent provisions were to be brought into effect only when the metallic portion had reached the limit of 50% and during the intermediate period the *temporary provisions* were to be operative. These were (1) that the securities of the Government of India in the Reserve were limited to Rs. 85 crores, and (2) the great loss and reduction in the amount of the securities consequent upon the revaluation of the gold and sterling securities at the new rate of 2s were to be made good by the specially created Rupee securities of the Government of India which were to be slowly replaced by sterling securities. But the creation of the *ad hoc* securities would have caused the limit of the rupee securities to exceed considerably. Therefore it was laid down that so long as the created securities exceeded Rs 12 crores, all interest on the securities in the Reserve, the profits on coinage of rupees and interest on the G. S. R., when it exceeded £40 m., as well as the interest on the commercial bills deposited with the Controller of Currency as security for emergency issue should be paid into the Reserve so that the excess of the *ad hoc* securities would be brought within the permissible limit. In this way the loss on revaluation would be made up to enable the permanent

provisions to be given effect to. In subsequent years, however, the financial difficulties of the Government led to the utilisation of these sources of income for revenue except in 1921-22. In pursuance of this Act the securities were revalued on 1st October, and the resulting deficiency was made up by issue of 12 months' Treasury Bills of the Government to the Reserve.

The Imperial Bank in 1921 was granted the authority to issue emergency currency the limit of which was raised from Rs 5 crores to Rs 12 crores. A Consolidating Act was passed in 1923. During 1923-24 Rs 2½ crores of emergency currencies were issued to relieve undue monetary stringency caused by the contraction of currency in 1921 and 22 to strengthen exchange. But their issue was hemmed in by the following conditions

- (a) Loans should be given to the Imperial Bank only when the Bank Rate rises to 6% and
- (b) Of the 12 crores the first 4 crores should be issued when the Rate is 6%, the second 4 crores when the Rate is 7% and the third 4 crores when the Rate is 8%. In September 1924 the rules were revised to enable the Bank to borrow Rs 4 crores at 6% and Rs 8 crores at 7%. The branches of the Bank provided increased facilities for encashment. In Feb-

ruary 1925 another Amendment Act was passed to increase the permissible limit of the securities from Rs. 85 crores, which was small, to Rs. 100 crores provided that the amount of the 'created securities' did not exceed Rs. 50 crores. The one rupee and 2½ rupee notes were withdrawn from January 1926.

The Hilton Young Commission —The Commission recommended that the Reserve Bank which they proposed should have the sole right to issue notes for 25 years and the power to have a judicious credit policy so that through its control of currency and credit it may be able to maintain the internal and external value of the monetary unit. The secure internal stability and elasticity the notes were to be issued against easily liquidating assets like commercial bills and for external stability a reserve was to be kept in gold and gold securities. Therefore the Commission proposed the Proportional Reserve System of Note Issue with separate Banking and Issue Departments under which *gold and gold securities* must not be less than 40% of the total liabilities (the total note-issue plus Rs 50 crores to provide for conversion of hoarded rupees into gold) and within ten years gold should ultimately be 25% of the liabilities with an over-riding minimum of 30 crores, and *Rupee securities* must not be more than 25% of the liabilities with an

over-riding minimum of 50 crores. A reasonable amount of rupee coins should be kept by the Bank to meet the demands of the public although there would be no obligation to convert its notes into rupees. The proportion of the silver was to be gradually reduced from Rs 85 to Rs. 25 crores during the next ten years.

The G S R. and P. C. R. were to be amalgamated and the proportion and composition of the combined reserves were to be fixed by statute. The notes of the Bank would be full legal tender and guaranteed by the Government whose notes should cease to be legal tender except at their Treasuries. The legal obligation to convert notes into rupees was to be withdrawn although facilities for the free interchangeability of the different forms of legal tender currency were to be granted and the new notes were to be convertible into gold bullion of not less than 400 oz. bars. *The Commission also proposed the reissue of one rupee notes as legal tender though they were not to be legally convertible into silver rupees.*

The recommendations of the Commission were embodied substantially in the Currency Act of 1927 but the Bill to create the Reserve Bank was thrown out in the Assembly. The gold and sterling assets of the P C Reserve were revalued at the rate of Rs 13-1-3 to the sovereign according to the Act of 1927 and this revaluation

caused an increase of Rs. 930 lakhs in their value which was set off by reducing the Indian Treasury Bills by the same amount

Reserve Bank Note Issue —The Bank began to function from the 1st of April 1935 when it took over the management of the Currency Department of the Government by opening an Issue Department of its own. The Government from this date ceased to issue notes. The G. S. Reserve was transferred and amalgamated with the P. C. Reserve from this very date. The Currency notes were supplied to it by the Government which together with its own notes are issued by it. The denominations of the notes are 5, 10, 50, 100, 500, 1,000 and 10,000. The Bank has however decided not to issue notes of Rs. 50 and Rs. 500 on account of their limited circulation although currency notes of the same denominations continue to be legal tender. The Bank first issued notes of Rs. 5 in January 1938, then of Rs. 10 in February and of Rs. 100 and Rs. 1,000 in May 1938. These notes are legal tender throughout British India, guaranteed by the Governor-General-in-Council and are convertible into silver rupees or smaller notes. The notes issued by the Burma branch of the Bank are legal tender only in Burma. The Issue Department is quite separate from the Banking Department and its assets and liabilities are shown distinctly separate

from those of the Banking Department. The assets of the Issue-Department consist of gold coin and bullion or sterling securities (balances at the credit of the Bank of England Issue Department, 90 days bills of exchange bearing two or more good signatures and drawn and payable in U. K., and U. K. Government securities maturing within 5 to 7 years) upto $\frac{2}{5}$ or 40% of the total liabilities (notes in circulation) and the value of the gold coin and bullion in the custody of the Bank is never less than Rs 40 crores, $\frac{17}{20}$ ths of this is held in British India. Gold for this purpose is valued at 847512 grains of fine gold to a rupee and the securities at market rates. The other $\frac{3}{5}$ ths of the Reserve are held in rupee, Government of India rupee securities of any maturity, and eligible commercial paper payable in British India, and the rupee securities are not more than $\frac{1}{6}$ of the total assets or Rs 50 crores whichever amount is greater, and with the previous consent of the Governor-General-in Council it may consist of such amount plus a sum of Rs 10 crores.

Like other Central Banks following the Proportional Reserve Method, the Reserve Bank is authorised, with the previous sanction of the Governor-General-in-Council for periods not exceeding 30 days in the first instance, which may with like sanction, be extended from time to time by periods not exceeding

15 days, to hold as assets gold coin, gold bullion, or sterling of less than $\frac{1}{5}$ ths of the total assets. During such period of deficiency the Bank shall pay a tax on the amount by which gold and sterling assets are reduced to less than $\frac{2}{5}$ ths, at the current bank rate with an addition of 1% per annum when such holding exceeds $32\frac{1}{2}\%$ of the total assets, and of a further $1\frac{1}{2}\%$ in respect of every further decrease of $2\frac{1}{2}\%$ or part of such decrease, provided that the tax shall not in any event be payable at a rate less than 6% per annum. The table over-leaf shows the composition of the Reserve and the progress of note circulation since April 1935.

Since July 1940, one rupee notes have been introduced and new one rupee notes have been issued since April 1941. They are equivalent to the rupee coin for purposes of the Bank Act. Since February 1943 the Bank has issued two rupees notes. There has been an unusual expansion of note issue particularly during 1942-43 and all denominations of notes except of Rs 50 have shared in it. The relative proportion of Rs 5 and Rs 10 notes declined between 1939 and 1942 from 61% to 55.7% while that of Rs 100 and Rs 1,000 notes increased from 37 to 44.1%.

ISSUE DEPARTMENT

LIABILITIES

	5 4 35	31 12 35	31 12 36	31 12 37	31 12 38	31 12 39	31 6 40	26 12 41	25 12 42
Notes held in the Banking Department	19 05	21 49	11 87	29 88	18 44	17 67	11 09	12 12	15 44
Notes in circulation	1 66 09	1 71 78	1 91 99	1 85 37	1 88 00	2 36 63	2 47 74	3 14 52	5 70 86
ASSETS									
Gold coin and Bullion	44 42	44 42	44 42	44 42	44 42	14 42	44 42	44 42	41 42
Sterling Securities	48 63	66 19	71 31	80 31	59 50	1 07 50	1 81 50	2 27 63	4 04 83
Rupee coin	49 95	57 12	64 76	62 56	70 19	64 04	93 31	94 18	14 17
Government of India Rupee Securities	43 05	25 54	23 37	27 41	32 32	38 84	49 60	41 50	11 22 88
Ratio of gold coin and sterling securities to total notes Issued	50 2	57 23	56 77	58 09	50 34	59 74	69 97	54 47	76 69

The branches of the Issue Department are at the same old circles' head quarters viz., Bombay, Calcutta, Cawnpore, Karachi, Lahore, Madras and Rangoon (Closed since the conquest of Burma by Japan)

CHAPTER XX

INDIAN CURRENCY AND THE PRESENT WAR

When Great Britain and France declared war on Germany on the 3rd of September 1939, then Indian Currency System was a *Sterling Exchange Standard* with the rupee linked to sterling at the artificial parity of 1s 6d. The rate of exchange was being maintained by the purchase and sale of sterling through the Reserve Bank of India between 1s 6 $\frac{3}{4}$ d and 1s 5 $\frac{1}{2}$ d. The rupee still retained its distinguishing features of a standard token coin, its convertibility into the paper tokens and the subsidiary coins internally and into sterling externally. It was inconvertible into gold and was in effect an inconvertible note printed on silver. The rupees and half rupees 11/12 fine were unlimited legal tender and the Subsidiary one anna, two annas and four annas coins of nickel and the copper pice and pies were limited legal tender upto Re 1. The external value of the rupee depended on that of sterling, which is divorced from gold, and which oscillates according to the changes in the economic conditions of Great Britain. All these features of the currency in India still continue unabated.

with two important changes—the reduction of fine silver in the rupee from 11/12 to $\frac{1}{2}$ and the introduction of the one rupee note which is at par with the rupee coin in all respects except the material of its print

The present war has affected the Indian currency and exchange system very powerfully and has led to the passing of a number of administrative measures influencing trade, currency, exchange, remittance, bullion, finance and prices. So far the system has successfully withstood the stress and strain of the war and the Bank Rate has remained steady at 3 p c. Production in general, prices and trade have received a powerful stimulus and note issue, deposits and security prices after a temporary disturbance and fall due to panic and uncertainty have shown a remarkable recovery. The Reserve Bank has followed a systematic policy of cheap money throughout and the continued maintenance of the Bank rate at 3% reveals the success of the Bank in its easy money policy. As a result of this policy and the fixing of minimum prices, the gilt-edged securities have been fairly stable* although the changing fortunes of the war have dominated the financial and

*Except towards the closing week of December 1942 when Calcutta had sporadic air raids the minimum prices were revised by the Government on 2nd September '42 and were in most cases higher than those of March

share markets and caused violent fluctuations in prices of industrial shares, *e g* the Tata* Deferreds fluctuated in 1940-41 between Rs. 1,600 and Rs 2,282 The financial and credit markets have been very powerfully influenced by the diversion of credit from normal peace-time productive channels to the manufacture of armaments and there has been a diminution in the production of non-military supplies.

The immediate effect of the war, like that of the Great War, was the *withdrawal of funds from the Post Office Savings Banks and Post Office Cash Certificates and deposits from the banks.* A tendency to sell out Government securities and *pro notes* also became pronounced With the enactment of the *Defence of India Act* a widespread rumour became rife that the Government were out to confiscate and control rigidly all private wealth and property and this intensified the withdrawal of funds from post offices The Government promptly contradicted and pointed out the absurdity

*With the withdrawal from 27th March, 42 of the minimum prices fixed in December 1941 for 28 shares on the forward list by the Bombay Stock Exchange, the industrial share market in Bombay began to go down and the Tata Deferreds dropped from Rs 1,520 on 25th March to Rs 1,210 on the 7th April, rose to 1 650 on 9th June, fell again below 1 400 From 19th Nov rose again from Rs 1,670 to 1 790 on 1st Dec dropped to 1,460 and then gradually rose to Rs 2 090 on 9th March Toward the end of the month they again dropped to Rs 1,822-8 0

of this panic and gradually public confidence was steadied and restored.

Since its Introduction in 1913-14 the Post Office Savings Banks have annually bagged large amounts of deposits except in 1914-15, 1917-18, 1921-22, 1930-31 and in 1938-39 the total outstanding amount of the deposits was 81.94 crores of rupees. In 1939-40 this figure fell down to 78.38 crores of rupees and to 59.57 crores in 1940-41. The total deposits in 1939-40 fell to Rs. 40.51 crores from Rs. 44.61 crores in 1938-39 and to Rs. 25.35 crores in 1940-41, Rs. 21.91 crores in 1941-42 and improved *slightly* to 22.26 crores in 1942-43. The receipts were better during the second half of last year and particularly so during the last two months, whereas the withdrawal increased from Rs. 41.65 crores in 1938.39 to Rs. 45.22 crores in 1939-40 thereafter fell to Rs. 45.09 crores in 1940-41, to Rs. 30.18 crores in 1941-42 and Rs. 22.84 crores in 1942-43. After the deduction of interest the net increase of Rs. 4.38 crores in 1938-39 was converted into a net decrease of Rs. 3.56 crores in 1939-40, of Rs. 18.81 crores in 1940-41 and of Rs. 7.44 crores in 1941-42. During 1942-43 there was a net increase of Rs. 15 lakhs. The rate of interest since December 1938 has remained constant at 1½% free of income tax. Since 3rd August 1942, cheques have been accepted in savings bank transactions and since 25th January 1943 the annual limit of net deposits has been in-

creased from Rs 750 to Rs. 1500 with effect from 1st Feb 1943. Since 5th April 1943 women have been allowed to open accounts through their agents. The withdrawals were very heavy during September 1939 and jumped from Rs 3.36 crores in August to Rs 7.95 crores in September, whereas the deposits fell from Rs 3.84 crores in August to Rs 2.76 crores in September. Thereafter confidence was restored and since October there were lower withdrawals than those of the corresponding months of 1938-39 and the deposits increased steadily although the monthly figures were a little lower than those of the corresponding months of 1938-39. With the reversal of the fortunes of the Allies in the war in May and the fall of France in June the withdrawals became heavy again. They amounted to Rs 7.01 crores in May and to Rs 10.11 crores in June as compared with Rs 3.03 and Rs 3.50 crores in the corresponding months of 1939-40. From July again the withdrawals showed a decline as did the deposits also. Since April 1941 the scheme of the Indian Post Office Defence Savings Bank has been introduced to encourage people of limited means to invest their savings in the assistance of war effort. The deposits in this scheme are payable only one year after the war and not on demand and they bear an interest of 2½% free of income tax. The deposits in the D. S. Banks in 1942-43

totalled Rs. 29 lakhs as against Rs. 11 lakhs in 1941-42. The receipts were heavier during the last quarter.

The sale of Post Office Cash Certificates which began in 1917-18 has also registered a sharp decline between 1939 and 1941, although the tendency towards a decline has been noticeable since 1935-36 as is evident from the following table :—

(In Lakhs of Rupees)

Year	Receipts	Repay- ments	Net Receipts	Amount Outstan- ding
1935-36	13.45	13.43	2	65.98
1936-37	14.88	16.46	—1.58	64.40
1937-38	13.97	18.16	—4.19	60.21
1938-39	14.71	15.35	—64	59.57
1939-40	10.25	12.80	—2.55	57.02
1940-41	4.89	14.93	—10.04	46.98
1941-42	3.97	11.94	—7.97	39.01
1942-43	3.76	8.20	—4.44	34.57

It is clear from the above table that the net receipts fell to Rs. 2 lakhs and thereafter the accounts show a net withdrawal which was the heaviest in 1940-41. During 1939-43 the issue prices remained unaltered with the interest at $2\frac{1}{2}\%$ compound, free of income-tax. The repayments in September 1939 after the outbreak of the war mounted upto Rs. 1.92 crores from 1.06 crores in August; whereas the sales fell from Rs. 1.27

crores in August to Rs 0.67 crores in September. From October onwards with the return of confidence repayments decreased and were actually lower than the repayment of the corresponding months of 1938-39, and the sales also improved, but they were much lower than the corresponding months of 1938-39. In May and June 1940 there were again heavy repayments and sharp declines in sales. During the 3 months May to July the withdrawals were Rs 6.64 crores as compared with Rs 2.89 crores during the corresponding period of 1939-40, whereas the sales declined from Rs 3.27 crores in 1939-40 to Rs 1.24 crores in May to July 1940. Thereafter confidence was restored and the repayments slowly came down to prewar levels. During 1942-43, the sales touched the low level of Rs 12 lakhs in March '42 but thereafter they increased and were high in the latter part of the year. But the total sales were lower at Rs 3.76 crores as compared with Rs 3.97 crores in 1941-42. Encashments also declined from May and were much lower during the last four months at 2.01 crores as against Rs 5.24 crores during the corresponding period of 1941-42. This was mainly responsible for the decline in the total encashments from Rs 11.94 crores in 1941-42 to Rs 8.20 crores in 1942-43. The sharp decline in the sales from Rs 10.25 crores in 1939-40 to Rs 4.89, 3.97, and 3.76 crores in 1940-41, 41-42 and 42-43 may be partly

due to the introduction of 10 year Defence Savings Certificates at 3½% compound interest free of income tax in denominations of 10, 50, 100 500 and 1,000. An individual's maximum holding has been limited to Rs 5,000 only. Upto 31st March 1941 Rs 241 crores worth of these certificates had been sold and Rs 12 lakhs withdrawn, leaving the amount outstanding at Rs 229 crores. During 1941-42 the receipts were Rs 281 crores withdrawals Rs 75 lakhs and the outstandings Rs 435 crores while the figures for 1942-43 were Rs 402 crores, Rs 81 lakhs and Rs 506 crores. The net investments in the aggregate in the certificates since June 1940 amounted to Rs 556 crores. Since 8th Feb 1943 scheduled banks have been authorised to buy D S certificates for their clients including minors without any indemnity clause in applications for purchase.

As to bank deposits, on the whole they have been steady and except for occasional set backs at the beginning of the war and in May and June 1940 they have increased. The total deposits of the scheduled banks increased from Rs 237.12 crores in April 1939 to Rs 414.45 crores in August but fell to Rs 241.32 crores showing a decrease of Rs 8.13 crores. In October they decreased to Rs 240.58 crores but thereafter they increased steadily and reached the highest recorded figure so far of Rs 259.26 crores in March 1940, and exceeded the figures of

last year by Rs. 21·30 crores. The increase was due to brisk demand for money for financing the movement of commodities and stock and silver markets. Then in June 1940 the total deposits fell to Rs. 253·98 crores from Rs. 260·87 crores in May, but thereafter, with the revival of confidence they steadily mounted up to Rs. 285·63 crores in March 1941 and reached to highest recorded figure of Rs. 304·31 crores at the end of June 1941. Throughout 1941-42 and 1942-43, there has been a substantial and continuous increase in the monthly average of demand and time liabilities of the scheduled banks. From Rs. 221·78 crores in March '42 the demand liabilities rose to Rs. 372·32 crores in March '43 while the time liabilities rose from Rs. 100·38 crores to Rs. 121·28 crores. There had also been a large increase in banks, advances and bills discounted upto 1940. During 1942-43 there has been a fall in loans and advances and in bills discounted but the position improved towards the end of the year.

To meet the growing demands of currency caused by the war the expansion of currency has led to a large increase in the investments of the Reserve Bank. The large purchases of the British Government and their Allies have resulted in huge accumulations of sterling resources on behalf of the Indian Government which has exchanged them with the Reserve

Bank for rupee currency, and the strength of the rupee sterling exchange has enabled the Bank to give substantial help to the Government of India in the *repatriation of their sterling debt*. The sterling securities held by the Bank increased from Rs 212 85 crores on the 27th March '42 to Rs 412 83 crores on 1st Jan 1943 and declined to Rs 345 83 crores on 8th Jan on account of the repatriation of $3\frac{1}{2}\%$ India Sterling Stock. They rose to Rs 421 71 crores in March 1943. The large investments of the Bank led to the profit of Rs 2,79,26,447-3-3 in the year ending June 1941, as compared with Rs 23 lakhs for the previous year, and out of this a sum of Rs 2,61,76,447-3-3 was transferred to the Government after the payment of $3\frac{1}{2}\%$ dividend to the shareholders. The figure of surplus profits later on were Rs 2 47 and Rs 32 4 crores.

The war has very powerfully affected the course and volume of our foreign trade. The declaration of hostilities led to the stoppage of all trade with the Axis powers and gradually the number of countries affected by the freezing order increased as the Germans conquered the European countries one after the other. A number of very important European markets have been lost to the country, and trade has been slack. The fall of France specially in June 1940 caused a setback to business and trade which were generally depressed during the

earlier part of the last year. The produce markets especially have been subjected to repeated upheavals. "Commodity prices which had been pursuing an upward course till the end of 1939 developed a recession, which culminated in a fall of as many as 23 points in the Calcutta Index Number of wholesale prices. The disasters which overtook France in the middle of the year, the shortage of shipping freight and the loss of European markets, combined with increases in taxation, created an atmosphere of uncertainty and nervousness which adversely affected the fortunes of the primary producer. In contrast with these conditions, the war had generally a favourable influence on most of our manufactures, the effects being the most marked in the paper, textile, and engineering industries which recorded substantial increases in production"¹ After this temporary setback the commodity prices advanced during the year and in June the general price level was higher than that of December 1939 and during the last quarter the rise was particularly marked.

In 1942-43 the prices of all commodities, both primary and manufactured, reached their peak and the country had to pass through a severe food crisis. Barring the

¹Sir Homi Modi at the Annual Meeting of the Central Bank of India

prices of sugar, wheat and kerosene, which were controlled, the prices of other necessities of life, and particularly of cloth, rose to unprecedented heights. To meet the situation dealings in futures and hoarding were made illegal but the ill-fated price control scheme of the Government proved an utter failure and it was abandoned towards the close of the financial year. In spite of control and restrictions on inter-district and inter-provincial movement of food stuffs and district food chests, and 'grow more food' campaigns the food crisis became threatening. According to the report² of the Reserve Bank "the problem of food would appear to be not solely one of inadequate production but also of maldistribution and to some extent of insufficient co ordination of governmental action'. The lack of adequate transport facilities due to the exigencies of the war, the abnormal conditions of demand and supply, the arbitrary division of the country into surplus and deficit food provinces, hoarding, unprecedented inflation, and pre occupation of the producers and manufacturers with war and only essential civilian supplies and not unhealthy speculation are the main causes of the peak prices prevailing. 'Wholesale prices have risen most in India, and least in the United States, Canada, Australia and S Africa

2 On Currency & Finance 1942-43

where they are generally higher by one-third as compared with the pre-war level."¹ The impact of inflation on prices and the economic structure in these countries has been prevented by the institution of a well conceived financial and economic controls. In India, after the initial spurt upto Dec. '39 the wholesale prices declined and reached the averages of 1929 in June 1941, but thereafter for 8 or 9 months the upward trend was restrained. But during 1942-43 there occurred a steep rise and it still continues unabated.² The Calcutta Index Number rose by 78.3% during 1942-43 against 24.4% in 1941-42 and 23% from August 1939 to March 1941, the corresponding rate of increase in prices in 1917-18 was 197 against 154 in 1916-17 and 23 from July 1914 to March 1916. The rise was more marked during the second half of the year. On the other hand, the general index of prices rose from 146 in April '42 to 220 in March '43 registering a rise of 50.7%. Food and tobacco moved up by 138 points during the whole year and by 107 during the second half, raw materials by 10 points. The prices of manufactured goods had risen faster than those of primary goods till 1941-42 and in 1942-43 their index appreciated by 63 points against 33 points in the previous year but the advance was less

¹ Reserve Bank Report 1942-43 ² Except cloth due to the Cotton Cloth & Yarn Control Order.

marked than in the primary commodities. *The cotton manufactures recorded an increase of 247 points from 195 to 442* followed by a rise of 83 points in steel. The Reserve Bank report says, "The rise in prices during the war which became particularly marked during the year under review may be alternatively described as an outcome of the growing shortage of purchasable goods in relation to increasing money demand, or of the increasing pressure of rising money incomes reflected in the expanding monetary circulation on a diminishing flow of goods for civilian use. The rise appears to be retained, on the one hand, by the retarded turnover of the increased money circulation, and accentuated, on the other, by difficulties of transport and distribution and artificial shortage induced by speculation and hoarding, which have led to discrepant price movements."

Although shipping difficulties and the blocking of so many old channels of trade have affected adversely the agriculturist, yet the loss of the European markets has been more than compensated by an unusual increase in the export trade with the Allies, especially Great Britain and the Empire Countries. In fact the immediate effect of the present war, unlike that of the Great War, has been a powerful impetus to exports and a slight improvement in imports with a remarkable increase in the balance of trade. During 1940-41, the

reverses in the fortunes of the Allies on the continent of Europe, causing a *loss of the European markets*, coupled with *scarcity of freight and restrictions on export and imports* (May 1940) depressed the imports considerably and even in exports the gains of the previous year were neutralised. The balance of trade therefore in favour of our country declined (excluding Government war transactions) although it remained even then much higher than the average balance of the previous quinquennium.

Year	Imports	Exports	Balance of Trade
1939 40	165 28	203 99	+38 64
1940 41	156 79	186 91	+30 12
1941 42	173 01	252 91	+79 90
1942 43	110 34	194 55	+84 21

The trade with continental Europe is practically stopped as also with Japan while imports from U S A have recently increased. Prior to the Japanese War on 7th of December 1941, the loss of European markets and scarcity of shipping trade had been seized by Japan which increased its share in our import trade by 25% in 1939 40 and by 40% in 1940 41 as compared with 1938 39. Exports to Japan declined by 36% in 1940 41. There was an adverse balance of trade with Japan to the extent of 5.3 crores in 1939 40 and 12.6 crores in 1940 41. All trade with Japan and Thailand ceased on declaration of hostilities. At the beginning of 1942 the freezing order was applied by the Govt to Hongkong, Malaya. British

N. Borneo & the Netherland East Indies and no dealings with them were permitted without the sanction of the Reserve Bank. "In the third the full year of the present war the value of India's foreign sea borne trade witnessed a recession, which was much more severe in respect of imports than of exports and the balance of trade improved to a small extent in consequence. In 1917-18, on the other hand, the balance of trade declined somewhat as a result of a slight decrease in exports while imports remained stable"* This big drop in the sea borne trade was due partly to the cessation of trade with Burma Imports fell by 36% from Rs 173 01 crores to Rs. 110 34 crores while exports declined by 22% from Rs. 252 91 crores to Rs 194.55 crores, the balance of trade increasing from Rs 79 90 to Rs. 84 41 crores. The fall in the value of imports was made up of a fall of $1/2$ in the quantum and an increase of $1/4$ in their price level which was practically doubled as compared with 1938-39 and the quantum fell to $3/10$. In exports the quantum declined by $1/3$ to $5/8$ of the prewar level while prices rose to about 85% above the average of 1938-39.

The course of trade has also undergone interesting changes during 1942-43. Exports to the Middle East—Turkey, Syria, Arabia and Iran—registered considerable improvements as also the imports from

* Reserve Bank Report 1942 43

these and Egypt. Exports and Imports from Ceylon, South Africa and Australia also increased. There was a reduction in both exports to and imports from, the United States. The exports to U.K & Canada also declined while the imports from U K increased. On the whole, however, the relative share of the Empire countries in exports increased from 62.7 to 67.71 p.c., while in the imports it declined from 61 to 55.5 p.c., and the balance of trade increased substantially from Rs. 43.32 crores to Rs. 64.54 crores, the exports to foreign countries from 27.3 to 22.9 p.c. and their balance of trade declined from Rs. 20.99 to Rs. 12.61 crores because of a greater absolute fall in exports to than in imports from these countries. Thus "a general feature of the trends in the direction of trade is the comparative decline of long distance traffic, which reflects alike the acute shortage of shipping and the increased risks connected with long ocean transport during the year"

Conversion of Notes and Hoarding of Rupees — Shortly after the start of hostilities a demand for the conversion of notes and the hoarding of rupees ensued. During the first four months of the war increased trade and speculative boom led to an abnormal absorption of notes upto Rs. 57 crores in addition to Rs. 11 crores of rupee coin and Rs. 1.41 of small coin, but in subsequent months the business demand for currency slackened and a demand for con-

version of notes and hoarding of rupees set in and reversed the trend of continuous return of rupee coin since 1920-21. Between September 1939 and April 1940 Rs 22 09 crores of rupee coin were paid by the Issue Department of the Reserve Bank of India. With the French reverses in the last week of May 1940, there was a raid by the public on the rupee coin and with the fall of France and the threatened invasion of the British Isles in June the weekly withdrawals rose to Rs 4 crores and the craze for hoarding intensified. This scramble for the rupee coin was met by the Bank in full and freely with a view to allay panic and stop hoarding and in June the Bank had to pay Rs 15 12 crores of rupee coin. From 15th of June to August no less than Rs 21 93 crores of notes were returned and the holding of the rupee coin by 24th May 1940 in the Issue Department fell below the statutory limit of Rs 50 crores from Rs 75 87 crores on 1st September 1939 and on 21st June it was only Rs 35 1 crores. Between 1939 and 1941 no less than Rs 43 31 crores of rupee coin had been absorbed. But the heaviest absorption has taken place during 1942-43 when the net absorption was Rs 44 97 crores against Rs 7 18 crores in 1941-42. The maximum annual absorption in the last war was Rs 45 02 crores. Since the war the absorption has been Rs 104 91 crores till March 1943. The absorption was particularly heavy during

October 1942 and March 1943—Rs. 42 15 crores.

The absorption of rupees through note conversion has also been accelerated by increased demand for currency to meet the heavy Government expenditure on defence and increased business and industry caused by the war. It was impossible for the mints working at even full pressure to meet this abnormal demand for rupee coin in adequate quantities and its disappearance from circulation was fraught with danger to the community and grave inconvenience to the public. The sudden withdrawal of over Rs 40 crores of currency in war time threatened a serious dislocation of trade and slump in prices. When the panic could not be allayed by meeting freely and in full the demand of the public, the Government on the 10th of June prohibited under the Defence of India Rules any person from refusing to accept coins or notes in payment of a debt or otherwise. The Government on 25th of June 1940 introduced a rationing* of rupees by making it an offence

* Rs. 50 in rupee coin and Rs 10 in small coin were regarded as ordinary individual requirements in Bombay while in Calcutta, Rs. 50 for an individual and Rs 300 to Rs 500 for a business firm were regarded as legitimate needs. Larger business and banks were supplied in full. Some 30 scheduled bank offices in Bombay met the demands of the public and 6 small change depots were opened on 4th and 10 on 5th July.

under the Defence of India Act for any person to acquire coin in excess of his personal or business needs, the determination of which was left to the judgment of the Reserve Bank or its duly appointed agents. This succeeded in reducing the demand for conversion of notes but it led to the demand for smaller lots. In 1939-40 Rs 2.63 crores of small coins had been absorbed during the first 7 months of the war but in the second year (1940-41) there was an absorption of Rs 4.26 crores in all of which half rupees and four annas pieces accounted for Rs 1.53 crores and Rs 1.02 crores. The absorption was very heavy during the period from May to July 1940 owing chiefly to the withdrawal of whole rupees for hoarding.

During 1942-43 there was an unprecedented demand for small coin of each denomination. Calcutta experienced a shortage due to panic and hoarding of copper coins caused by a steep rise in its price in August 42 and later the scarcity spread to other parts and reached its peak in November when the maximum monthly absorption was about Rs 1.55 crores. Coupons and stamps were called into service in various parts of the country and the Government penalised excessive acquisition and possession under the D I R. As a result of these measures and additional supplies the situation improved substantially by the end of the year. Total absorption

of small coins was Rs 11.64 crores or, 148% greater than the previous record absorption of 4.69 crores in 1941-42. Bombay and Calcutta mints were turning out small coins at the rate of 72 m. pieces a month as compared with a monthly average of 16m in August 1939 and 34m in April 1942. From Jan. 1943 the Calcutta mint has been working an additional shift and by end of March 1943 the mintage reached 136 m pieces a month or by 89% over the output of Dec. 1942. A new mint at Lahore is to work from August with a monthly capacity of 30m pieces. The total mintage during 1942-43 amounted to 963m. pieces or 40% of the total output of small coins in war.

Measures to meet the situation —The heavy withdrawals of rupee coin were causing a good deal of inconvenience to the public on account of scarcity of a unit of exchange smaller than the 5 rupees note. To meet this need therefore the Government promulgated an Ordinance with immediate effect on 24th July 1940 providing for the issue of *one rupee notes* and putting them into circulation. They were made equal to the silver rupee in every respect by declaring that they would be unlimited legal tender and would be as fully, and to the same extent, current in British India as the rupee coin. They were also deemed to be equivalent to the 'Rupee Coin' for all the purposes of the Bank Act 1934 and to facilitate their immediate circulation through

the Reserve Bank the Ordinance made suitable amendments to the Bank Act. They are issued by the Bank in exchange of its own notes to supply the demand of the rupee coin. As new one rupee notes could not be supplied in adequate quantities immediately, so the issue of one rupee notes printed in 1935, to meet the contingency caused by a threatened rise in the price of silver beyond the rupee melting point on account of the silver purchase policy of U S A in 1934-35, was arranged. They are $3\frac{1}{8} \times 2\frac{1}{8}$ in size and bear the effigy of His Late Majesty King George V and the signature of Mr J W Kelly. The popularity of the one rupee note led to the issue of new notes $4 \times 2\frac{1}{2}$ in April 1941.

With a view to relieve the growing demand for rupee coins and notes the Bank issued on 1st February 1943 the two rupees note $4\frac{1}{2} \times 2\frac{1}{2}$ in size from Bombay. They were put into circulation during the course of the year in Bombay, Lahore, Cawnpore and Calcutta and amounted to Rs 140 lakhs at the end of the year.

To restrict the negotiability of notes with political slogans the Government deprived their legal tender character on 31st October 1942, although the Reserve Bank was authorised to refund in its discretion the whole or part of their value. From 26th March 1943 the making or use

of documents resembling currency or bank notes has been made punishable by law.

There has been an acute shortage of small coins. On account of a rise in the face value of the coins above their metallic contents in the black market, there was a tendency to hoard them. Their withdrawal was causing a good deal of inconvenience to the public for making small purchases. To provide against this withdrawal and hoarding the Government notified on 23rd January 1943 that a new design of pice, with a smaller diameter and a circular hole in the centre, reduced in weight from 75 grains to 35 grains and containing 97% copper $2\frac{1}{2}\%$ zinc and $\frac{1}{2}\%$ tin, instead of the former fineness of 95 $\frac{1}{2}\%$ copper, 3% tin, $1\frac{1}{2}\%$ zinc, would be minted and the mintage of half pice and pie pieces would be discontinued. The new pice was issued from Bombay on the 1st of February 1943.

To bring the rupee holdings upto the statutory minimum of Rs. 50 crores the Bank received Rs. 12 crores of rupee coin from the Government under section 36 (2) as amended on 24th July 1940. To meet the increasing needs for rupees the Bank received on seven different occasions Rs. 35 crores in all from the Government of India against cancellations of *ad hoc* treasury bills and credit to Central Government.

To meet the increasing demand for the half rupees and four anna pieces the

Government decided to issue fresh coins, but with a view to discourage the hoarding of these coins and to avoid waste, involved in minting of coins of the existing fineness viz 11/12, it amended the Indian Coinage Act 1906 by an Ordinance on 26th July 1940 and reduced the fineness of half rupee from 11/12 fine silver and 1/12 alloy to half silver and half alloy. By amending the Coinage Act on 11th March 1940, the silver fineness of the four anna pieces had already been reduced from $41\frac{1}{4}$ grains of fine silver to $22\frac{1}{2}$ grains which had brought the Indian four anna bits in line with the British subsidiary coins of 50% fineness.

Victoria rupees upto mintage of 1876 were being withdrawn from circulation before the war according to Article 75 (a) of the Resource Manual and rupees of the mintages of 1877 to 1901 were being withdrawn in accordance with the circular of the Controller of Currency dated 1st October 1936. With a view to improve the composition of rupee in circulation, the withdrawal had been accelerated from October 1938 by removing restrictions on the receipt of light weight Victoria rupees and by giving the discretion of accepting at full value coins of doubtful genuineness to the Treasury and Sub-Treasury Officers without loss to themselves. Since November 1939 Victoria half and quarter rupees are being withdrawn slowly. The Indian Coinage (Second Amendment) Ordinance of 11th

October 1940, recalled the Victoria rupee and half rupee coins with effect from 1st April 1941 and the Government notification directed that, on and from that date, these coins would cease to be legal tender except (a) at the Bombay and Calcutta Offices of the Issue Department of the Reserve Bank of India until further notice, and (b) at any Government treasury or post office till the 30th September 1941. During 1939-40 nearly Rs 12.03 crores and in 1940-41 Rs 5.54 crores of Victoria coins had been recalled. This step had been taken to improve the composition of rupee circulation, to avoid counterfeit coins and to recover the rupee and half rupee coins of standard weight and fineness from idle and uneconomical hoards. Restrictions on the acceptance of light weight coins including George V coin were removed and all Treasury Officers and Agents of the branches of the Imperial Bank of India were instructed in January 1941 not to examine silver coins for their light weights but only for their genuineness.

By the (Third Amendment) Ordinance of 23rd December 1940, new security edge rupee coins of the fineness of one-half silver and one half alloy, already adopted for half-rupees and quarter rupees, were introduced to meet the growing demand for rupee coin for increased trade activities and hoards and to remove the inconvenience or unsuitability of the new rupee notes for some rural areas. The security edge

device in the new design of the rupee is considered a virtually absolute safeguard against counterfeiting and consists of the insertion in the centre of the milled edge of a shallow re-entrant groove inside which is a design in two sections separated by blank spaces. This design consists of alternate beads and diagonal lines in relief. The ring of the new rupee is also duller and it bears the date '940. Upto March 43 Rs 54.29 crores of quaternary rupees had been minted.

Finally on the 8th of December 1941 the Government issued a notification to recall the rupee and half rupee coins bearing the effigy of His Late Majesty King Edward VII which were to cease to be legal tender with effect from 1st of June 1942 except (a) at the offices of the Reserve Bank Issue Department at Bombay Calcutta and Madras until further notice and (b) at any Government treasury or post or telegraph or public call or rail office till 30th September 1942.

In pursuance of its policy to progressively replace the standard silver rupees by the quaternary rupees, King George V and King George VI standard silver rupees and half rupees of 11/12 fineness were also withdrawn from circulation by a Notification dated the 1st Oct 1942 and these coins ceased to be legal tender from 1st May 1943. They were, however, to be accepted

at Treasuries, Post Offices and railway stations upto 31st Oct 1943 and thereafter only at the offices of the Reserve Bank at Bombay, Calcutta and Madras, until further notice. But on 16th November 1942, the Government notified that Victoria Edward VII, George V and George VI standard rupee and half-rupee coins were not to be accepted even at the offices of the Reserve Bank, the first two with effect from the 1st May 1943 and the last two with effect from the 1st Nov 1943, except in cases where the tenderer proves to the satisfaction of the Bank that he could not present them before the above dates on account of circumstances beyond his control. Commenting on these notifications the Reserve Bank Report says, that they "marked the culmination of the policy which originated more than 50 years ago of converting the rupee which had previously been a full value silver coin into a token. The maintenance of such a high silver content as 11/12 fine had, besides being expensive, exposed the rupee to unduly speculative influences, and with the Indian price of silver nearly equal to the metallic content of the standard silver rupee, the Government saw no reason why hoarders of standard silver coin should be given an indefinite option either to return it at its full nominal value or to melt and sell it as bullion."

The withdrawal of the full-blooded rupee coins from circulation by means of ordi-

nances had caused a good deal of misgivings and suspicion in the minds of the general public and it was the war time abnormal trade and industrial activities which were maintaining the new one rupee notes and coins in circulation side by side with the old rupees. As a result of this suspicion and operation of the Gresham's Law the 22 carat fine rupees were bound to go out of circulation and to be hoarded. It was mainly with a view to discourage their withdrawal into idle hoards and the consequential risks to trade and business that the recall of the Edward VII and George V and George VI rupees and half-rupees had been made. The increased demand for rupees and the consequent pressure of work on the two mints at Bombay and Calcutta had led to the erection of an additional mint at a cost of Rs 65 lakhs at Calcutta with a normal capacity of coining Rs. 6 lakhs a day. It is to be further extended after the war to mint subsidiary coins also.

Exchange Control and Restrictions —Like the British Government, the Government of India have also instituted a policy of exchange control and restrictions under the Defence of India Ordinance 1939. The outbreak of the war and the consequent dislocation of the exchange market caused the prices to rise erratically and both the London and Bombay bullion markets were closed from 2nd to 4th September and from

4th to 7th September respectively. On 5th September the United Kingdom Government under the Defence Regulations prohibited dealings in gold, pegged sterling to dollar at 4.02 to 4.06 and the Bank of England fixed its purchase price of gold at 168 s. per fine ounce. The sterling-dollar rate was later on fixed at 4.02 to 4.04 on 14th September and on 8th January 1940 to 4.02½ and 4.03½. Owing to steady exports and purchases by the Reserve Bank the rupee price of gold, remained relatively stable at a higher level and on the outbreak of the war the Defence of India Ordinance 1939 prohibited exports and imports of gold except on the licence granted by the Reserve Bank under conditions which were issued by it on 4th September and 13th October. In March 1941 to prevent smuggling the taking of gold out of India in any form without the permit of the Reserve Bank was prohibited by amending the Defence of India Rules. The prohibitions of gold import in any form under the Sea Customs Act still continue unabated. The price of silver also rose sharply at the outbreak of the war on account of speculative purchases and the appreciation of the dollar and with a view to conserve the foreign exchange the British and Indian Governments notified on 26th and 30th October respectively their prohibition of silver imports except under licence. On the 14th of December 1939 it was announced

that the sale of silver, which was till then made through London, for delivery ex-Mint, Bombay, would thereafter be made through the Bombay office of the Reserve Bank of India. On the 18th of December 1939 the Bombay Bullion Exchange rules were adjusted for prompt delivery by the Mint of rupee silver (916 $\frac{2}{3}$ fine) at a discount of Rs. 2/9/- under silver of 999 fineness and the Reserve Bank introduced its scheme of licensing imports of silver on a profit sharing basis even from the non sterling areas and fixed the minimum and maximum prices for the sale of imported fine silver at Rs. 62 and Rs. 64 per 100 tolas. On 11th of March 1940 a sale price of Rs. 62 per 100 tolas was fixed for profit sharing under the licensing plan. During the last week of March 1941 the Bank issued licences for import of silver from New York. The restrictions on exports and imports of gold still continue. For the last 8 months there has been no export of gold from India, and although the bullion market has been free from outside influences, yet the price of gold touched new high levels during 1942-43 (Rs. 72 in Bombay). The retail price went up to Rs. 100 afterwards. This has been the result of increased demand for investment and speculation in the face of reduced supplies and record number of marriages this year. This hoarding and speculation have maintained the price of gold over the export parity.

and prevented its export. The price has now come down to Rs 73.75 again and the government has prohibited banks to advance loans against bullion.

The production of silver in 1942-43 was lower than that of 1941-42 and its average price in Bombay was Rs 92 12 11 with a difference of Rs. 41-4-0 between the maximum and the minimum. When on 31st August the price of Indian silver in London went beyond 23½d. per oz. its sale at the American acquisition rate for imported silver was stopped. The demand for silver for ornaments and coinage was then met from British official stocks to replenish which the government secured under the Lend Lease from U S A 325 m. oz. and purchased from Canada 175 m. oz. Upto August the Reserve Bank supplies checked speculation and rise in prices of silver but thereafter the suspension of sales by it and the political disturbances caused an orgy of speculation and the price shot up to Rs 116 8-0 on 8th November which was the highest price since May 1918, Rs 75-4-0 on 18th April was the minimum price of the year. The rise with favourable war news and the Lend lease promise to allied nations for coinage the price receded to Rs 95-8 0 by 17th December. From February the price began to rise again and reached Rs 112 10 on 12th of March, closing at Rs 111-6 on the 31st. The surcharge of 20% on import tariff was continued for

1943-44 making the import duty Rs. 8-7 per tola.

The sterling exchange market (Bombay rate for T T on London) has remained remarkably steady at 1s. 5 $\frac{1}{2}$ d. since October 1939. When due to lack of shipping freight the number of export bills was very few on 29th March 1941, while private remittances were considerable, the rate showed signs of breaking down for lack of cover and was lowered to 1s. 5 $\frac{1}{8}$ d. Thereupon the Reserve Bank announced its readiness to sell sterling cover at 1s. 5 $\frac{1}{2}$ d. for ready and upto 3 days forward delivery. Only a small amount was sold to stabilise the exchange at 1s. 6d. In October 1939 the bank introduced a novelty in the Currency System by announcing its willingness to buy sterling upto 3 months forward at rate 1/32d. higher per month than the spot rate with a view to enable the banks to do forward exchange business which had then been paralysed by the difficulty of getting cover in London for position other than spot and the consequent rise in the discount rates there. The tap rate was also raised by the Bank in the same month to 1s. 6d. with a view to tone up the rate for ready T. T to 1s. 5 $\frac{1}{2}$ d. The 3 months' forward purchase of sterling was raised to 6 months forward at 1s. 6d. on February 12, 1940. Since then the Bank has continued to buy sterling both ready and forward upto 6 months at 1s. 6d.

The Bank made record net purchases of sterling amounting to £91,672,123 @ an average rate of 1s 6d in 1942-43 as against £73,319,614 in 1941-42 at the same rate. This was due to considerable decline in imports and the consequent increase in favourable balance of trade. Since September 1939 the Bank has purchased sterling amounting to Rs 387 crores and received from His Majesty's Government Rs 571 crores. In August 1939 the Bank had sterling assets valued at Rs 64 crores. Thus between August '39 and March 43 the Bank had Rs 1022 crores of sterling assets, of which Rs 180 crores had been utilized for repatriation of the sterling debt and other commitments made up Rs 131 crores, leaving the sterling holdings of the Bank at Rs 511 crores at the end of 1942-43 against Rs 284 crores at the end of 1941-42.

On October 16 1940 the Bank notified that the exporters of gold from India to United States must surrender 34 dollars for each ounce of gold exported and that it would purchase dollars for spot delivery. That is to say, before an export licence could be granted gold had to be sold to the reserve Bank which purchased dollars resulting from gold shipments. Upto February 1940 the buying and selling of certain foreign currencies from and to authorised dealers in India was done by the Bank of England and the Reserve Bank did

not buy any foreign currency except the U. S. A. dollars. As the new export control regulation introduced in March 1940 caused a great increase in foreign currency bill so the Reserve Bank of India thereafter began to purchase from the banks Belgian and Swiss francs and Dutch and Java guilders of delivery upto 4 months and U. S. A. dollars upto 6 months at a rate based on its sterling buying rate of 1s 6d and the Bank of England buying rates for these currencies. The banks were also accorded permission to cancel their contracts without loss if they failed to fulfil their contracts on account of un-controllable war conditions. Both ready and forward delivery rates were the same and on 1st April 1940 they were as follows —

U. S. A. dollars	4 03½ to the £
Belgian francs	23 70 to the £

(plus ¼% commission with a sterling buying rate of 1s 6d)

Dutch guilders	7 58 to the £
Java guilders	7 55 to the £
Swiss francs	17 95 to the £

The invasion of Holland and Belgium by Germany led to the suspension of the purchases of Belgian, Dutch and the Javanese currencies on May 11th 1940 but on May 28 the Bank resumed the buying of Java guilders for spot delivery only at 7 62. On October 15th the rate for the Swiss francs fell to 17 40 after which date

no further changes occurred during the year upto March 1941. In Sept 1942 the Govt. of India prohibited the import of currency or bank notes from Burma into India whereas the import of Bank of England notes upto £10 per head, Chinese dollars upto 100 dollars per head, and notes of other countries without limit, was permitted, if they were declared to the customs on arrival. The export and import of rouble notes were also prohibited. To help Indian evacuees from Ceylon in exchanging their notes, after Japanese air raids in April and May 42, arrangements were made for the purchase of Ceylon currency notes at all offices of the Reserve Bank treasuries and branches of the Imperial Bank. The Bank has been exchanging at fixed rates foreign notes of soldiers and travellers from the Allied countries. Elaborate arrangements for the encashment of Burma notes were made under the Burma Notes Ordinance in June 1942 and earlier in January at various places in the country.

The Exchange Control Department of the Reserve Bank made arrangements in December 1940, in pursuance of the Government decision in November, for the acquisition of the dollar balances of all residents in British India and for the payment to the holders of these balances in rupees at the rate of Rs. 100 per \$ 100. Finally on March 10th, 1941 the holdings of residents in India of

certain American securities were taken over by the Government at their market prices in New York on the previous business day at the dollar rupee rate of Rs. 330 to \$ 100. The E. C. D. of the Reserve Bank has collected and classified the securities and made arrangements for their delivery in New York and payment for them in rupees here. On account of the German conquests, the scarcity of shipping freight and the submarines, mines and U-boats menace the supplies of certain essentials including heavy goods like machinery and steel and motor vehicles for the mechanisation of the Indian Army and luxury goods etc. have ceased from the continent of Europe, and India has had to depend upon U.S.A. mostly for these supplies. These increased purchases from U.S.A., in spite of severe import restrictions on non essentials and luxury goods, have necessitated an ever-increasing volume of dollar exchange to pay for them, and hence the necessity of conserving the dollar resources for the needs of the Empire, for the acquisition of dollar balances and securities by the Government and the Reserve Bank and increased restrictions on imports and exports. Only people travelling in national interest are granted dollar exchange and no remittances to Canada or U.S.A. are permitted.

Part XIV of the D.I. Rules issued in September 1939 provided for control of all

dealings in coins, bullion, securities and foreign exchanges and authorised to Reserve Bank to administer this exchange control. On 4th September the Bank issued instructions in this behalf and shortly afterwards established an Exchange Control Department for the purpose. Under the guidance of the Bank of England all the Empire countries have instituted a co-ordinated exchange control policy. For exchange control the Empire, excepting Canada, Newfoundland and Hongkong, was regarded as one currency unit called the 'sterling area', within which free transfers of funds are permitted but dealings in foreign currencies have been restricted to genuine trade purchases, travelling expenses and small personal remittances. This sterling area which included the mandated territories, Egypt and Iraq also was extended with the inclusion of the Belgian Congo, Iceland, the Faroe Islands and the Free French territories during 1941. It was further extended by the inclusion of Madagascar and its dependencies on 28th December 1942 and free exchange dealings were also permitted with F Somaliland and Reunion on their declaration for the Free French. The underlying idea of this control policy is that only authorised dealers in foreign exchange (the Exchange Banks and certain scheduled banks licensed for the purpose) are permitted to do foreign exchange business at rates based on the

rates of the London Exchange Control and the current rupee sterling rate

The Government has acquired under the D. I. Rules all foreign exchanges and securities and restricted dealings in them and has prohibited any direct or indirect acquisition of foreign exchange and dealings in it and gold. Authorised persons by the Reserve Bank are free within their authority to buy or sell and persons are also allowed to acquire foreign exchange for meeting business needs in fulfilment of pre-war contracts and for reasonable travelling or personal expenses. Banks are also forbidden to sell exchange except to residents in India, but are allowed, to enter into forward contracts covered with genuine trade transactions. The regulations thus ensure that foreign exchange is obtained only for financing trade, for certain approved purposes, for remittances for essential purposes and prevent any flight of capital and speculative arbitrage dealings in exchange.

There are five kinds of remittances for the purpose of regulation *viz*, (i) Payment for imports, (ii) Petty private remittances, (iii) Travelling expenses, (iv) Freight, profits and royalties etc., and (v) Capital remittances. The last category of remittances has been rigidly controlled and it is in very exceptional cases that the Bank permits them. But the authorised dealers are allowed to sell exchange in payment for

imports on an undertaking to produce Customs Entry Form as proof of the goods having been imported into India. For petty remittances and travelling expenses reasonable facilities have been granted upto certain limits and, if very large sums are involved, prior approval of the nearest office of the Reserve Bank is necessary. For other trade purposes (vi) reasonable facilities are also provided on the production of suitable documentary evidence from Chartered Accountants etc., that the money was being utilised for the purposes stated. Transfers to 'non-resident' accounts i.e., accounts outside the sterling area, are allowed only on the production of documented forms. Each authorised agent has to submit a daily statement of its sale of foreign exchange supported by application forms to the E.C.D. of the Bank for inspection and check. Changes in the political situation caused by the changing fortunes of war have led to a tightening of the control for conserving exchange for essential purposes only and the privileges of the authorised dealers have been curtailed to the extent that, with the exception of payments for licensed imports and a limited number of private remittances, they cannot sell foreign exchange without prior reference to the Reserve Bank. All allowances to British or Indian nationals outside the sterling area have now to be approved by the Bank in accordance with the Government policy.

and foreign exchange for travelling is refused except for urgent trade or Government business. The authorised dealers are permitted to sell exchange either to the Bank of England or Reserve Bank on its behalf and to buy from the Bank of England with the approval of the Reserve Bank cover for their sales of exchange to the public for approved purposes. They can deal with other banks in India and can buy from or sell freely to, local dealers. If their weekly exchange position shows that they are heavily overbought they can sell surplus exchanges to the Bank of England if they are not needed locally.

When restrictions on remittances made straddle business with New York impossible the Bank introduced a system of licensing authorised cotton dealers to enable them to purchase dollar exchange if they surrendered all their dollar profits to it. Similarly, when dealings in foreign securities and balances were immobilised by the prohibitory order of the Government, the Bank introduced a system of licences for the holders of these securities and balances to enable them to retain their holdings and to change their investments or invest their balances with the permission of the Bank. These licences were cancelled when the Government took over the dollar balances and securities.

Similarly licence has to be issued by the Bank to permit travellers to take out

jewellery and cash beyond the prescribed figure. Severe restrictions have also been imposed on the purchase of Bank of England notes by banks in India to prevent a disposal of large holding of these notes captured by the Germans from the conquered territories in Europe.

With regard to *exports* there were no regulations for export finance nor were steps taken to ensure that foreign proceeds of shipments were returned to India except the prohibition of acquisition of foreign exchange under the D I Rules and restriction on drawing of sterling bills on non-Empire countries. Shippers were advised to draw their bills in foreign currency. The Bank of England had fixed rates for buying and selling foreign currencies. The United States of America and Switzerland, Holland and Belgium, whose currencies were freely convertible into dollars (gold) were called '*hard currency*' countries. The rates of the Bank of England applied only to dealings in the United Kingdom and the Empire countries and dealings in New York and other outside markets were free. This outside market was called '*free*' market and the rate for sterling in this market oscillated violently on account of the changing political and monetary conditions. Sterling was soon quoted at a discount in New York and this fact made it more profitable to sell Empire goods to U. S. A. and other '*hard currency*' countries on a

sterling basis than to sell them on a foreign currency basis, because the foreign importer was able to buy sterling cheaply for payment of his imports in the 'free' *sterling market*. Taking advantage of this difference in rates the greater proportions of India's exports to U. S. A. for the first few months of the war were financed through sterling bills on London. "Rupee-dollar transactions were forbidden at other than the basis of the official London rates, and by an agreement with American banks, the rupee rate in New York was quoted on same basis as the dollar in India, and no 'free' market in rupees was allowed to develop. As the sterling rate in the 'free' market depreciated the advantages of financing trade with U. S. A. through sterling increased and there was a difference of 20% between the official rate and the New York sterling quotation. It failed to 3.20 as against the official rate of 4.03½. To stop this loss of foreign exchange the Bank of England, towards the end of March 1940, instituted an *export control system* allowing exports of certain commodities to 'hard currency' countries only on the production of satisfactory evidence that the shippers were obtaining hard currency and not 'free' sterling for their exports. Other Empire Control Boards imposed similar restrictions in their countries at the same time.

To control the proceeds of exports to

'hard currency countries the Reserve Bank introduced its *Export control scheme* in the beginning for jute (raw and manufactured) and rubber* but later on extended to include all commodities shipped from India to nearly all countries except those occupied by the enemy or those adjacent to India lacking banking facilities. The chief objects of the scheme are to ensure that full proceeds are received and are not retained outside the Empire and that the exports are financed in specified ways to get maximum exchange value. Therefore exports against direct remittances in hard currencies or against bills drawn in them are permitted and drawing of sterling bill on the importing country which could be paid in 'free' sterling are prohibited, but sterling bills on London are allowed if they are drawn under letters of credit registered with the Bank of England and contain a clause to the effect "that the sterling provided to meet the bills at maturity was obtained by the sale of U S dollars to the London control. The financing of exports in rupees has been permitted on the production of satisfactory evidence that rupees were provided by the foreign importer at official rates and were not remitted through the 'free sterling' market. The export control system is

*In June 1940 it applied to all goods exported to U S A and Switzerland

worked through the customs and banks by means of forms filled by the exporter and showing value and the method of financing of his shipment. One of these forms is delivered to the customs for export permit and the others are given to the bankers for discounting bills. Later on these forms are sent to the Reserve Bank for checking and inspection. These export regulations have led to an interesting change in the methods of export financing. *The traditional method of financing Indian exports has been the drawing of bills on London in sterling. Now they are financed mostly through bills in foreign currency and direct sale mostly in U S A dollars.* This has been due to the cessation of fast air mails after the collapse of France and the removal of the financial gain in the sterling bill by the export regulations. Goods sold to U S A through London merchant houses or brokers are still financed by sterling bills on London but the bulk of the business is now done directly on U S dollar basis.

Under the Export Control Scheme since 1941 there are different methods of financing exports to non sterling areas which vary according to the classification of the importing country into a Registered A/c country (U S A and dependencies) a Special A/c country (Canada and Newfoundland) etc. Exports to countries outside the sterling area, excepting Arabia, Iran, Afghanistan, and Tibet since 31st May

1941 have been permitted only on the declaration of the shipper as to the method of finance employed, and the name of the bank through which the payment is to be received. The shipping documents are forwarded through an authorised foreign exchange dealing bank for realisation of the proceeds. The bulk of exports from India to such countries is financed thus under bank credits and foreign exchange payments are received within 6 months. The despatch of parcels to such countries is also under a like system of control and the P. O. does not accept any parcel without a certificate from an authorised foreign exchange dealer that the parcel was worth less than Rs. 50 and had no exchange value, or return of its proceeds to India had been arranged. These certificates are sent by the P. O. to the Reserve Bank which also receives the duplicate copies from the banks. For exports to China the exporter's declaration to Customs has to be countersigned by a bank certifying that the payment had been received through an approved bank from China or an irrevocable letter of credit had been opened before the export permit. Exports for sale or consignment are not permitted because the Chinese Stabilisation Board grants permit for imports only for goods for which they allot foreign exchange. Exports of goods unlicensed by the Board are prohibited. The chief methods of export finance are

(a) financing through direct bills in American dollars or other currencies of the countries of destination (b) financing through sterling bills on London, (c) financing through sterling bills on the country of destination in which case the payment is effected in sterling from a Special A/c (d) financing through rupee bills and (e) other sundry methods

Under the D I R the Freezing Orders to prevent the enemy obtaining funds or foreign exchange were applied at the beginning of 1942 to the accounts of persons and firms resident in Hong Kong, Malaya, British Borneo and the Netherland East Indies because of their conquest by the Japanese. No transactions on such accounts were allowed without the prior sanction of the Reserve Bank, although cheques drawn prior to the freezing orders were paid as also those in which the Bank was satisfied that the amounts did not fall into enemy hands. Normal credits for interest on securities, rents or debts due to the residents of such areas and debits for insurance premia, subscriptions and support of relatives were also permitted. Similar orders had been applied to the accounts of persons in occupied China. Prior to this the freezing order of 30th July 1941 covered the a/cs of all Chinese residents with a view to help the Chinese Government control foreign exchange assets and transactions of their own national in the sterling areas.

It still continues in force for the residents of free China. The a/cs of the Chinese National Government and other Government organisations were specially exempted from the freezing order. For non-resident a/cs credits and debits are not made without the prior approval of the Reserve Bank except in case of transactions with Iran, Afghanistan and Saudi Arabia.

When with the stoppage of imports from Continental Europe India had to make her purchases of heavy goods like machinery, motor transport and other steel manufacturers from America, the volume of dollar exchange needed for the payment of these imports increased considerably. This increased strain on the dollar resources of the Empire necessitated conservation of foreign exchange for the needs of industries, and therefore in May 1940, the Government introduced an *import licensing scheme* for certain commodities like machinery and other industrial needs from certain countries without any detriment to any essential Indian interest. Many imports have been replaced by nascent supplies or supplies from countries with which exchange problem is not acute. In pursuance of this policy the Reserve Bank issued necessary instructions to the authorised dealers in foreign exchange and prohibited the sales of exchange against unlicensed imports of such commodities as were subject to the import control policy. Restrictions on private remittances and for

non-trade purposes were made more rigid and severe and travelling by non-Empire ships was forbidden as also the sale of foreign exchange to travellers to non-Empire countries unless their journey was in the interests of the country or was undertaken on Government business. The control was extended to a large number of goods in August 1941 and the controlled goods were classified into 'A' and 'B' classes.

The control and regulation of exports of all goods to U. S. A. throughout the sterling area diminished the volume of sterling passing to the 'free' market and a still further fall therefore in the 'free' sterling rate had occurred with a reduced supply and static demand. To curtail the operation in this sterling market still further the Bank of England entered into '*payment agreements*' with the main countries trading with the Empire. As a result of these agreements all sterling payments between the Empire and such countries passed through the official sterling accounts in London at fixed rates and no payments of sterling were made through the 'free' market. Such agreements were made with U. S. A. and Switzerland through their leading banks which undertook to open Registered Accounts in sterling in London and to stop further operations in 'free' sterling. They were guaranteed supply of dollars or francs in exchange at official rates as also the purchases of these from them by the Bank

of England as required. All sterling operations henceforth were made through these accounts but dealings in dollars and francs were still allowed. Other countries had to settle all operations in sterling from special sterling accounts in London and no transactions in their own currencies were permitted except in case of Sweden. Transfers between these special accounts were forbidden and therefore the receipt of any sterling balances by a country for its exports to the Empire were utilised for imports from the Empire. A limited 'free' sterling market however still existed because China, Japan, Iran, Afghanistan and Thailand did not enter into such agreements. This market has been further restricted with the Japanese war because all trade with Japan and Thailand has been stopped. The Reserve Bank advises banks and merchants here with regard to payment agreements and establishes suitable procedure for financial operations with foreign countries. Before the entry of Japan into the war and after the entry of Italy and extension of war to the Middle East, and East Africa, the importers in the Middle East, Egypt, Sudan and E Africa were compelled to obtain their supplies of Japanese goods through Bombay. This entrepot trade had to be controlled to ensure that India did not supply foreign exchange for which she received no return. Prewar shipments were permitted to be financed by Indian mer-

chants but banks were prevented from selling exchange in payment of foreign goods re-exported to countries outside the sterling area unless the Bank was satisfied that an equivalent exchange was received in payment of the re-exports. For re-exports within the sterling area banks were permitted to sell exchange on the production of a certificate by the purchaser from the Exchange Control Board of the importing country authorising the expenditure of foreign exchange.

The upshot of all these restrictive measures and exchange control and regulation is the pegging of rupee sterling exchange at 1s 6d. sterling.

The war has undoubtedly put a severe strain on our financial system and caused the imposition of fresh taxation and substantial increases in existing duties and taxes. To meet the heavy expenditure on defence caused by the expansion and mechanisation of the army the supplementary Finance Bill in November 1940 *inter alia* imposed a 25% surcharge on income-taxes and enhanced the postage, telegram and telephone charges and imposed an excess profits duty. Upto March 1941 an additional taxation of Rs 25 crores had been imposed and still the budget for 1941-42 showed 'a prospective deficit of 20,46 lakhs to meet which the excess Profits Duty was increased to 66%, the surcharge on income-

taxes to 33½%, the excise duty on matches was doubled, an extra duty of Re 1 per cwt on sugar, and of 2 annas per gallon on petrol was imposed, artificial silk yarn and thread, pneumatic tyre and tubes etc. were subjected to fresh levies. In September further amendments in duty on matches were made to make available banderols for boxes or booklets containing on an average more than 40 but not more than 60 matches at Rs 3 per gross of banderols, those containing more than 40 but not more than 50 at Rs 2/8/-, and those containing more than 50 but not more than 60 and Rs 3 per gross of banderols. There have been further increase in the rates of Income tax, Super tax, Corporation tax and imposition of excise duties in 1942-43. These included a surcharge of 66⅔% over the existing basic rates on the slabs of incomes, an increase of ½ anna in the surcharge on Super Tax between incomes of Rs 25,000 and Rs 3½ lakhs and in the Corporation Tax, an excise duty of 1 anna to Rs 1/2/- per lb on unmanufactured tobacco and 2 as. to Rs 6 per 100 rupees on manufactured tobacco, an excise duty of Rs 7 per cwt on *Vanaspathi* reduced later in March 1943 to Rs 5/- and increases in postal and telephone rates. In addition to these taxes the Government have raised loans on 6 years 3% Defence Bonds, 10 years Defence Savings Certificates, 3 years Interest Free Bond, 3% Defence Loans (three) and

Defence Savings Stamps of 4 annas, 8 annas and Re 1 etc In connection with the repatriation of sterling debts, there have been issued their rupee counterparts Upto March 1943 the total receipts from all these loans and sales amounted to Rs 301 50 crores The currency and finance systems have thus successfully withstood the strain and stress of the war and they are expected to maintain their strength and vitality in future with the Reserve Bank of India being there to husband our resources

An interesting feature of the war time finance and exchange, to which reference has already been made earlier in the chapter, has been the *repatriation of terminable sterling debt of India to England* The Government of India had been repatriating our sterling debt since 1937 but on account of a reduction in the Government remittances it was temporarily stopped. The Government by that time had redeemed £9½ m of their liabilities on account of the Family Pension Funds transferred to England The repatriation has been effected in two ways—through *purchases by the Reserve Bank* in the open market and through a *license scheme* announced on 22nd February 1940 The large sterling balances accumulated on behalf of the Government of India, since the outbreak of the war, due to heavy imports from India into England, have revived the old scheme to utilize these

huge balances for debt redemption. On 8th of February 1940 the British Treasury under Defence Finance Regulations announced financial transactions involving £90 m whereby the holders of 6 Indian Government sterling loans were to sell them to the British Treasury at the price ruling on Friday following. These were then to be handed over to Indian Government at the same price for cancellation and and were to be paid out of the sterling balances in London.

This operation has released large sums for investment in the New British Government tap loans. The huge sterling balances accumulated in London have enabled the Bank of England to follow a cheap money policy, have increased the quantity of loanable funds and maintained the gilt-edged securities stable, have eased the task of balancing the budget without inflationary borrowing and have spelt the success of the various defence loans. To India, it has meant a substantial reduction of her sterling and foreign debt replaced by corresponding rupee and internal debts and has thus reduced Government remittances to their intense relief in these hard times and diminished the amount of interest payments. In fact it has meant the utilisation of funds hitherto earning a low interest in short term money market for the redemption of long term debts carrying higher interest. Out of a total of £900 m.

sterling debt there has been a redemption of £307. 26 m at a total cost of Rs 408 08 crores by 1942 43. The Government have been considering a scheme for making advance provision for the requisite sterling remittances to meet future payments of sterling pensions, family pensions and provident funds out of the sterling balances with the Reverse Bank. Over £ 6 m. a year would be required for it. Altogether this capitalisation scheme would involve an amount of £ 150 m. leaving still substantial and growing balances available for other purposes.* The proper utilisation of these balances has given rise to an acute controversy in the nationalist press which is opposed to the proposed capitalisation scheme of the disbursement of sterling balances for the reconquest of Burma and for the defence of Iran and Iraq. It alleges that the sterling balances would thus pass into the hands of the British Government. It would like the balances to accumulate in dollar and see them utilized for the post-war reconstruction and mechanisation of Indian industries.

*Sir J. Raisman F. M. of the Government of India